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The Future of Backdating Equity Options in the Wake of SEC Executive Compensation Disclosure Rules

For decades, institutional investors and activist shareholders have expressed increasing concern over lucrative compensation packages for corporate executives, specifically those at underperforming companies.¹ Equally frustrating to many shareholders is the method by which large corporations determine executive compensation packages—a process rife with complexities² and informalities,³ affording management ample opportunity to

1. See Jill E. Fisch, *The New Federal Regulation of Corporate Governance*, 28 HARV. J.L. & PUB. POL'Y 39, 40–41 (2004); Terence O'Hara, *Many Executives' Paychecks Swelled, No Matter How They Did*, WASH. POST, July 10, 2006, at D7; see also Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275, 284–87 (2000) (summarizing the litany of shareholder proposals surrounding executive compensation issues in recent years).

2. See Nell Minow & Kit Bingham, *Executive Pay: Investors Care*, LEGAL TIMES, Sept. 28, 1992, at 22, 25 (noting that executive pay packages are often submerged in “opaque proxy-speak”). Even sophisticated financial analysts often have difficulty surmising the precise amounts being paid to corporate management. According to Minow and Bingham, *The Wall Street Journal* once reported that the salary of a certain CEO had increased to \$7.3 million when, in reality, the salary had increased to \$11.4 million. *Id.* Analysts from *The Wall Street Journal* had been forced to delve into nineteen pages of dense proxy statements in order to ascertain the CEO's precise compensation. *Id.* at 25. For a discussion of the debacle, see Patrick J. Straka, Comment, *Executive Compensation Disclosure: The SEC's Attempt To Facilitate Market Forces*, 72 NEB. L. REV. 803, 805–06 (1993).

3. Carol J. Loomis, *'This Stuff Is Wrong'*, FORTUNE, June 25, 2001, at 73, 74–80 (stating that “compensation committees are really in the pockets of CEOs”). The informalities often associated with executive compensation decisions exist partially as a result of the delegation of compensation matters to special committees charged with determining and overseeing the pay packages extended to senior executives. See Iman Anabtawi, *Secret Compensation*, 82 N.C. L. REV. 835, 848 (2004) (“[T]he CEO of a company plays an active role in the [compensation committee] selection process. The CEO is generally expected to recommend and discuss candidates with the nominating committee and to recruit candidates [M]embers who are hand-picked by the CEO are often senior executives at other companies or individuals who share the same worldview as the CEO. The result is that even independent directors may be predisposed toward insiders.” (footnotes omitted)); see also Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FIN. 1829, 1851 (1999) (discussing the significant influence of CEOs and top executives on the selection of board and committee members). Though the precise role of a corporation's compensation committee may vary depending upon the specific delegation of authority from the board of directors, compensation committees are typically charged with recommending pay levels for top management, approving employment agreements, and administering incentive-based option plans. See generally Anabtawi, *supra*, at 841

significantly “influence[] the terms of their own remuneration.”⁴ In many cases, shareholders have difficulty even surmising the precise amount of executive compensation because of the labyrinth of creative compensation techniques that have been steadily evolving in both sophistication and complexity.⁵

After a series of devastating and high-profile corporate scandals,⁶ federal regulators and lawmakers have increased their scrutiny of executive compensation in recent years.⁷ In many cases, this scrutiny has led corporate managers and directors to be more discreet, enhancing their compensation so as to minimize adverse shareholder reaction and circumvent pressures from the investment community.⁸

(discussing the shortcomings of special compensation committees in effectively controlling executive pay packages). These special compensation committees have evolved primarily as a result of new complexities in executive compensation and additional regulatory requirements imposed by the SEC. See BRUCE R. ELLIG, *THE COMPLETE GUIDE TO EXECUTIVE COMPENSATION* 510–12 (2002).

4. See, e.g., Anabtawi, *supra* note 3, at 841–42 (outlining the litany of methods by which top executives influence compensation committees). During an empirical study of executive compensation trends, one anonymous CEO admitted that compensation committees and nonmanagement board members were at a significant disadvantage when overseeing matters of executive compensation. See Loomis, *supra* note 3, at 73–74. Another executive posited that “[b]asically, what people understand they have to do is go along with management, because if they don’t they won’t be part of the club. You sort of get rolled over by the system even if you try to do well.” *Id.* at 76; see also ELLIG, *supra* note 3, at 511 (noting that the addition of independent directors on a compensation committee may have diminishing results, as management officials are far more apt to be versed in executive compensation techniques).

5. TED ALLEN & SUBODH MISHRA, *INSTITUTIONAL S’HOLDER SERVS., AN INVESTOR GUIDE TO THE STOCK OPTION TIMING SCANDAL 1* (2006), available at <http://www.issproxy.com/pdf/OptionTiming.pdf>.

6. Corporate bankruptcies at blue-chip giants Enron, WorldCom, Qwest, and Global Crossing spawned an era of increased awareness as to executive compensation techniques and the manner by which executives influence the terms of their own compensation. See Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 754 (2002); Paul Krugman, *For Richer: How the Permissive Capitalism of the Boom Destroyed American Equality*, N.Y. TIMES, Oct. 20, 2002, (Magazine) at 62, 66.

7. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.); JAMES HAMILTON & TED TRAUTMANN, *SARBANES-OXLEY ACT OF 2002: LAW AND EXPLANATION* 13 (CCH 2002) (commenting that the public outrage stemming from the collapse of Enron and WorldCom prompted Congress and President Bush to adopt new measures aimed at addressing the systematic and structural deficiencies affecting American capital markets); Christopher Wyant, *Executive Certification Requirements in the Sarbanes-Oxley Act of 2002: A Case for Criminalizing Executive Recklessness*, 27 SEATTLE U. L. REV. 561, 562 (2003) (“Collectively, this legislation is embodied in the Sarbanes-Oxley Act of 2002 . . . , which impacts nearly every aspect of the system that brings financial information from a public corporation to existing and potential investors . . .”).

8. See Anabtawi, *supra* note 3, at 852.

As the backdating scandal aptly illustrates,⁹ many executives have found the opportunistic timing of option grants¹⁰ to be “an especially attractive way to enhance executive compensation both because it is difficult to detect and because it has generally eluded [the] attention” of shareholders and investment professionals.¹¹

Much like the corporate scandals of the past, the practice of backdating¹² equity option grants poses a serious potential problem under federal securities law and “strikes at the heart of the relationship among a public company’s management, its directors, and its shareholders.”¹³ Amid the widening backdating scandal, the Securities and Exchange Commission (“SEC”)¹⁴ recently promulgated a new set of executive compensation and related-party disclosure rules,¹⁵ representing the most significant overhaul of benefit disclosure policy since 1992.¹⁶ The new regulations,

9. See *infra* notes 25, 65 and accompanying text.

10. Equity option grants permit an executive to purchase shares of the company’s stock for a specified price at some point in the future. In theory, stock options are aimed at aligning the interests of shareholders and management by creating a personal financial incentive for the executive to increase shareholder value. For a general discussion of stock option grants, see Z. Jill Barclift, *Corporate Responsibility: Ensuring Independent Judgment of the General Counsel—A Look at Stock Options*, 81 N.D. L. REV. 1, 8–10 (2005).

11. Anabtawi, *supra* note 3, at 852.

12. The term “backdating” has now been widely adopted among academics, regulators, and investors as the pejorative characterization of the opportunistic timing of option grant packages. Although “backdating” is not necessarily a term of art, it is important to understand the practice to which the term applies. See *infra* notes 110–12 and accompanying text.

13. Christopher Cox, Chairman, Sec. & Exch. Comm’n, Options Backdating: Remarks Before the Committee on Banking, Housing, and Urban Affairs, United States Senate 1 (Sept. 6, 2006), http://banking.senate.gov/_files/ACFB067.pdf.

14. The SEC operates as an independent regulatory agency within the executive branch. See JIM BARTOS, UNITED STATES SECURITIES LAW: A PRACTICAL GUIDE 2 (3d ed. 2006). The Commission is charged with the administration of federal securities statutes and has been delegated expansive regulatory powers by Congress. See *id.*; THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION 3 (5th ed., rev. 2005) (explaining the differing types of rulemaking authority that have been conferred upon the SEC) Although the SEC is comprised of only five commissioners serving at the pleasure of the President, the Commission is staffed with hundreds of lawyers and investment analysts. The SEC is generally considered to be one of the most effective and approachable federal agencies. See BARTOS, *supra*, at 254.

15. See Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 228, 229, 232, 239, 240, 245, 249, 274).

16. Terence O’Hara, *SEC Rules Tightened on Pay Disclosure; Firms Must Detail Total Compensation of 5 Top Executives*, WASH. POST, July 27, 2006, at D1. The executive compensation disclosure rules promulgated by the SEC in 1992 provided shareholders with standardized and plain-English disclosure of executive pay packages. See Executive Compensation Disclosure, 17 C.F.R. §§ 228, 229, 240, 249 (2006). The 1992 disclosure rules enabled “shareholders to find out in a matter of minutes what used to take hours to

unanimously adopted by federal regulators in July of 2006, take effect in the upcoming proxy season commencing in the spring of 2007.¹⁷

Having spawned more than 20,000 official comments, the new executive compensation disclosure rules have generated more interest than any other set of proposed regulations in the SEC's seventy-two-year history.¹⁸ The new rules are extraordinarily broad in scope, encompassing over ninety pages of the Federal Register and tackling a litany of issues ranging from related-party transactions¹⁹ to tabular disclosure requirements.²⁰ However, this Recent Development addresses the specific provisions of the regulations dedicated to the disclosure of backdated equity option grants. The backdating disclosure provisions of the new regulations require that publicly traded companies disclose detailed information regarding the rationale for executive stock option plans, as well as the justification for any potential backdating that may have occurred.²¹ According to regulators, these new disclosure rules are intended not only as a means of enhancing corporate accountability, but also as an effort to address the backdating scandal that has recently ignited public fury.²²

However, the new executive compensation disclosure rules serve only as a symbolic gesture, reinforcing existing federal securities laws that already mandate the disclosure of backdated options. The newest disclosure rules represent only a feeble—and with all likelihood fruitless—attempt at combating the increasingly abusive

determine, namely, how much the company's CEO and other top executives reaped from their compensation packages for the year." James E. Heard, *Executive Compensation: Perspective of the Institutional Investor*, 63 U. CIN. L. REV. 749, 752–53 (1995) (summarizing the four major changes brought about by the 1992 executive compensation disclosure rules).

17. Although the executive compensation disclosure rules do not officially take effect until the spring 2007 proxy season, "certain interpretations of the existing proxy rules contained in the [new rules] will apply to [the 2006] proxy statement." Steve Bochner, *Client Memorandum—SEC Proposes Major Overhaul of Executive Compensation Disclosure—What You Need To Know This Year, February 2006*, in *ADVANCED SECURITIES LAW WORKSHOP 2006*, at 399, 401 (Practising Law Institute ed., 2006); see also Cox, *supra* note 13, at 3 (stating that "in the next proxy season beginning in the spring, all public companies will now report this information in clear, easy to understand tabular presentations").

18. See Press Release, U.S. Sec. & Exch. Comm'n, SEC Votes to Adopt Changes To Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), available at <http://www.sec.gov/news/press/2006/2006-123.htm>.

19. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,197.

20. *Id.* at 53,163.

21. *SEC Adopts New Regulations on Executive Compensation, Perks*, FOX NEWS, July 26, 2006, <http://foxnews.com/story/0,2933,205689,00.html> [hereinafter *SEC Adopts New Regulations*].

22. *Id.*

corporate practice of backdating option grants. Moreover, by mandating only increased *disclosure* of backdated options,²³ rather than instituting a blanket prohibition of such practices, the SEC appears to have at least tacitly accepted the legitimacy of these deceptive, and arguably illegal, practices.²⁴

At the outset, this Recent Development discusses applicable background law pertaining to the issuing of equity option packages, including the various rationales for backdating options, the adverse effects on shareholder value, and the extent of the widening option timing scandal.²⁵ Next, this Recent Development details the backdating provisions of the executive compensation disclosure rules²⁶ aimed at enhancing shareholder knowledge of manipulative option timing practices and discusses the shortcomings of the new regulations with regards to effectively combating the practice of options backdating. Finally, this Recent Development will offer guidance for future SEC action that more directly addresses the problem of manipulative option timing.

To evaluate the merits of the SEC's newest disclosure rules, a brief discussion of contemporary trends in option-based compensation is in order. The issuing of an equity option grant permits the recipient to purchase a specified number of shares of a company's publicly traded stock at a specified strike price.²⁷ Many option plans are limited in the scope of their exercise period or have special vesting requirements to promote long-term incentives to

23. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,163 (“[T]he Commission believes that in many circumstances the existence of a program, plan or practice to time the grant of stock options to executives . . . would be material to investors and thus should be fully disclosed in keeping with the rules we adopt today.”).

24. For a detailed discussion of the legality of backdating equity option grants, see *infra* notes 112–35 and accompanying text.

25. During the summer and fall of 2006, the option backdating scandal quickly became the hottest topic in federal securities law. Venerable blue-chip companies such as Apple, Home Depot, and Barnes & Noble—each historically reputed for their impeccable corporate governance practices—have been among those placed under the regulatory microscope as the SEC and Justice Department continue to expand the scope of inquiries into executive option packages at some of the Nation's largest publicly held companies. See, e.g., Grace Wong, *A Primer for Firms Hit by Stock Option Scandal*, CNN MONEY, Oct. 11, 2006, http://money.cnn.com/2006/10/11/technology/options_backdating (discussing the extent of the widening criminal and regulatory probe into improper backdating practices).

26. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,158.

27. ELLIG, *supra* note 3, at 357; see also Anabtawi, *supra* note 3, at 840 (discussing the logistics of equity option plans and their influence on the behavior of corporate executives).

corporate executives.²⁸ Because equity option grants inherently link an executive's compensation to the value of the company's underlying stock, public companies generally adopt executive stock option plans to improve the performance of management²⁹ and create a proprietary interest in the company to better align shareholder and management interests.³⁰ Properly structured equity option packages provide top executives with "a great incentive to raise the company's share price, which increases both the value of his or her options and shareholder returns."³¹ Directors have also found that lucrative stock option plans are the most effective means of attracting and retaining talented executives in an increasingly competitive corporate marketplace.³² A less apparent, though equally beneficial aspect of adopting executive stock option plans, includes the ability to decrease corporate tax liability³³ while ensuring favorable accounting treatment.³⁴ Maintaining a healthy balance of equity option grants in

28. See ELLIG, *supra* note 3, at 357.

29. Steven A. Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation*, 7 DEPAUL BUS. L.J. 301, 306 (1995); Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31, 37-38 (2000).

30. Eric L. Johnson, *Waste Not, Want Not: An Analysis of Stock Option Plans, Executive Compensation, and the Proper Standard of Waste*, 26 J. CORP. L. 145, 148 (2000); see also Thomas & Martin, *supra* note 29, at 38-40 (determining that one of the primary purposes behind equity option plans is to "provide managers and employees with a proprietary interest in the company"). See generally Roy F. Price, *Options, Waste and Agency Costs in the Corporation*, 4 S. CAL. INTERDISC. L.J. 391 (1995) (discussing the economic rationale of equity option grants in executive compensation packages). Congress has also created tax incentives aimed at encouraging corporations to use equity option grants as a form of executive compensation. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 251(a), 95 Stat. 172, 256-59 (codified at 26 U.S.C. § 422 (2000)). Through these tax benefits, Congress recognized that properly structured equity option plans "provide an important incentive device for corporations to attract new management and retain the service of executives who might otherwise leave, by providing an opportunity to acquire an interest in the business." Michael W. Melton, *The Alchemy of Incentive Stock Options—Turning Employee Income into Gold*, 68 CORNELL L. REV. 488, 500-01 (1983) (quoting S. REP. NO. 97-144, at 98-99 (1981)).

31. ALLEN & MISHRA, *supra* note 5, at 1; see also Cox, *supra* note 13, at 2 ("[A] properly structured option plan can be useful in more closely aligning the incentives of shareholders and managers. And for growth companies, the use of stock options as compensation offers a way to conserve resources while attracting top-flight talent in highly competitive markets.").

32. See Mark A. Clawson & Thomas C. Klein, *Indexed Stock Options: A Proposal for Compensation Commensurate with Performance*, 3 STAN. J.L. BUS. & FIN. 31, 39-44 (1997); Melton, *supra* note 30, at 488; Thomas & Martin, *supra* note 29, at 37.

33. See Richard H. Wagner & Catherine G. Wagner, *Recent Developments in Executive, Director, and Employee Stock Compensation Plans: New Concerns for Corporate Directors*, 3 STAN. J.L. BUS. & FIN. 5, 14 (1997).

34. In 1972, the Accounting Principles Board issued Opinion 25, entitled "Accounting for Stock Issued to Employees." ACCOUNTING PRINCIPLES BD., ACCOUNTING FOR

executive pay packages also allows corporate directors to better deflect shareholder allegations of excessive executive compensation.³⁵

The disadvantages of equity option packages, however, are well documented and widely acknowledged. By increasing the number of outstanding shares, option grants often dilute the interests of existing shareholders.³⁶ Moreover, option grants with short vesting periods can create incentives for management to focus on short-term increases in the company's stock price while neglecting the long-term interests of shareholders and precluding sustainable corporate growth.³⁷ Some commentators have even suggested that lucrative equity option packages may create perverse incentives for management to ignore federal securities laws in an effort to ensure short-term financial results.³⁸

In light of the competing advantages and disadvantages of equity option packages, the SEC has explicitly elected to remain neutral on the subject,³⁹ allowing equity option plans to evolve into the centerpiece of many executive compensation packages.⁴⁰ However, "[a]s the use of options compensation has increased . . . so apparently has its abuse."⁴¹ In a feeble attempt to ensure that option plans

STOCK ISSUED TO EMPLOYEES, OPINION NO. 25 (1972) (superseded by SHARE-BASED PAYMENT, FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FIN. ACCOUNTING STANDARDS NO. 123 (2004)). Under the provisions of Opinion 25, a company is required to recognize a compensation expense on its income statement for any difference that may exist between the market price of the company's stock on the date of the grant and the option's exercise price. *See id.* Hence, a company need not account for equity option expenses on corporate earnings statements unless the exercise price is less than the fair market value of the security on the day the award is issued. *See id.*

35. Bank, *supra* note 29, at 302 ("[C]ompanies have turned more toward stock-based compensation as a means of both preserving the deductibility of executive compensation and placating disgruntled shareholders.").

36. JAMES HAMILTON, EXECUTIVE COMPENSATION AND RELATED-PARTY DISCLOSURE: SEC RULES AND EXPLANATION 80 (2006).

37. *Id.*

38. Rajesh Aggarwal, *Executive Compensation and Corporate Controversy*, 27 VT. L. REV. 849, 849–50 (2003).

39. HAMILTON, *supra* note 36, at 79 ("The SEC does not seek to encourage or discourage the use of stock options or, for that matter, any other particular form of executive compensation.").

40. Anabtawi, *supra* note 3, at 836; *see also* Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 847–48 (2002) (noting that the total compensation of CEOs during the 1990s increased almost 300% from \$2.3 million to nearly \$6.5 million and that the increase during this time period largely reflected a significant increase in the value of equity option plans, which increased from 27% to 51% of the total executive compensation).

41. Linda Thomsen, Dir., Div. of Enforcement, Sec. & Exch. Comm'n, *Executive Compensation and Options Backdating Practices: Remarks Before the Committee on*

properly align the interests of shareholders and management, most companies structure option plans in a method that ensures an exercise price equal to the fair market value of the underlying security on the day that the grant is issued.⁴² Consequently, most companies award option grants at-the-money,⁴³ meaning that the exercise price is equal to the fair market value of the stock on the day in which the grant is issued.⁴⁴ At-the-money option grants have generally been popular with American companies because the costs of these awards are categorized as performance-based compensation and are therefore deductible from corporate tax returns,⁴⁵ even in cases where the executive's annual salary exceeds one million dollars.⁴⁶

Because the value of an equity option decreases as the exercise price gets higher, executives naturally prefer that the stock price be as low as possible on the day that the award is issued, thereby increasing the value of their compensation.⁴⁷ Option backdating takes place when a company retroactively sets an option exercise price to an earlier date, when the fair market value of a particular security is less than the current trading price.⁴⁸ One of the earliest shareholder derivative actions filed in the wake of the backdating scandal equated the practice of backdating option grants with "picking lottery numbers on the day after the winning numbers are reported in the

Finance, United States Senate 2 (Sept. 6, 2006), <http://finance.senate.gov/hearings/testimony/2005test/090606testilt.pdf>.

42. Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802, 803 (2005).

43. See generally Brian J. Hall & Kevin J. Murphy, *Optimal Exercise Prices for Executive Stock Options*, 90 AM. ECON. REV. 209 (2002) (estimating that approximately 95% of all option grants occur at-the-money).

44. The exercise price of an option grant is generally calculated by using the stock's closing price on the day in which the grant is awarded or by averaging the stock's high and low trading price on the day of the grant. See ALLEN & MISHRA, *supra* note 5, at 1.

45. Equity options must be granted either at or above the market value of the stock on the day that the grant is awarded to qualify as "performance based compensation" under § 162(m) of the Internal Revenue Code. Option grants that qualify as performance based compensation under § 162(m) are tax deductible even in cases where the executive's total annual compensation exceeds \$1 million. I.R.C. § 162(m)(1) (2000); Treas. Reg. § 1.162-27(e)(2)(vi)(A) (as amended in 1996); see also *Enron: Joint Committee on Taxation Investigative Report on Compensation-Related Issues: Hearing Before the S. Comm. on Finance*, 108th Cong. 75-76 (2003) (statement of Pamela Olson, Assistant Secretary, Tax Policy, Department of the Treasury) ("[T]he 'performance-based' exception has encouraged many companies . . . to shift compensation . . . into stock options and other forms of compensation tied to the company's stock price.").

46. ALLEN & MISHRA, *supra* note 5, at 1.

47. Lie, *supra* note 42, at 803.

48. ALLEN & MISHRA, *supra* note 5, at 1.

news.”⁴⁹ Effectively, the practice of backdating creates an “in-the-money” option, where an executive is permitted to purchase shares of the company’s stock at a lower price than the fair market value of the stock on the day the grant was originally awarded.⁵⁰

Federal regulators contend that a wide range of publicly held companies illegally created in-the-money options by “misrepresenting the date of the option grant, to make it appear that the grant was made on an earlier date when the market value was lower.”⁵¹ The practice of backdating equity options involves a rare and unusually complex “convergence of accounting, tax and securities regulation . . . and carries the potential for serious civil and criminal consequences.”⁵² For example, backdated in-the-money options are not considered performance-based compensation and do not qualify for the tax benefits or favorable accounting treatment typically afforded to traditional, at-the-money stock option packages.⁵³ The rationale for disguising an in-the-money option grant by retroactively backdating the award is to allow the executive to realize an immediate financial windfall without having to disclose the expense as compensation on the company’s yearly financial statements.⁵⁴

The investment community has long speculated that directors and corporate executives may have engaged in deceptive and opportunistic timing of equity option grants.⁵⁵ High-profile corporate

49. Complaint at 2, *St. Paul Teachers’ Ret. Fund Ass’n v. McGuire*, No. 06-CV-01959 (D. Minn. May 18, 2006).

50. Cox, *supra* note 13, at 1.

51. *Id.*

52. Vinson & Elkins LLP, Options Backdating Update (July 26, 2006), http://www.velaw.com/resources/resource_detail.asp?rid=000322803901&rtype=pub.

53. *See id.*

54. ALLEN & MISHRA, *supra* note 5, at 1; Cox, *supra* note 13, at 2.

55. ALLEN & MISHRA, *supra* note 5, at 3. *See generally* Keith Chauvin & Catherine Shenoy, *Stock Price Decreases Prior to Executive Stock Option Grants*, 7 J. CORP. FIN. 53 (2001) (speculating that executives were manipulating the timing of equity option grants); David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FIN. 449 (1997) (discussing suspicious market movements in the immediate wake of unscheduled option grants). In addition to the practice of backdating equity option grants, several articles have addressed the more prolific problem of “springloading” option grants to coincide with favorable news releases. *See, e.g.*, Stanley Keller, *Stock Option Pricing Practices Occupy Center Stage*, in STOCK OPTION PRICING PRACTICES: WHAT YOU NEED TO KNOW 9, 12 (Stanley Keller ed., 2006) (“The grant of options before the disclosure of material nonpublic information likely to affect favorably the market price of a company’s shares has been called ‘springloading.’ ”); David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON. 73, 75 (2000) (providing an overview of abusive springloading practices). One common variation of the popular practice of springloading

scandals at Enron, WorldCom, and Tyco have all demonstrated the potential for management to enhance the value of equity option grants by manipulating the process by which companies award options to executives.⁵⁶ The SEC has consistently voiced concern over option granting practices, although abusive option practices now appear to have reached maximum proportion in the wake of the current backdating frenzy.⁵⁷ Indeed, Congress has attempted to stem the tide of abusive option practices on several occasions, though the fruits of these efforts have been largely unrealized.⁵⁸

Several early empirical studies indicated that option grants tended to occur on days when the price of the underlying security was conveniently low.⁵⁹ In May of 2005, Erik Lie, a professor at the University of Iowa, conducted a comprehensive study of nearly 6,000 equity option grants that took place between 1999 and 2002.⁶⁰ Professor Lie's study found a highly pronounced pattern of

option grants is "bullet-dodging," which involves the postponement of option grants until unfavorable corporate information has been properly addressed. *See* Keller, *supra* at 13.

56. *See* Stuart L. Gillan & John D. Martin, *Financial Engineering, Corporate Governance and the Collapse of Enron* 31 (Univ. of Del. Coll. of Bus. & Econ., Ctr. for Corp. Governance, Working Paper No. 2002-002, 2002), available at http://papers.ssrn.com/sol13/papers.cfm?abstract_id=354040 (revisiting the corporate accounting scandals at Enron and WorldCom); *see also* Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1247 (2002) (theorizing that Enron executives, because of their massive profits from earlier option grants, turned the corporation into a "hedge fund, taking leveraged bets in exotic markets that if successful would produce a huge, disproportionate bonanza for its executives").

57. Keller, *supra* note 55, at 11 (contending that the SEC's most recent concerns over option granting practices has resulted from increased media attention and academic studies that have suggested deceptive option timing practices).

58. In 2002, for example, § 403 of the Sarbanes-Oxley Act amended § 16(a) of the Securities Exchange Act of 1934 in an effort to reform existing reporting requirements that accompany equity option grants. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 403, 116 Stat. 745, 788 (codified at 15 U.S.C. § 78p(a)(2)(C) (2000 & Supp. IV 2004)). Prior to Sarbanes-Oxley, directors were not required to disclose option grants until the end of the fiscal year in which the award took place. *See* M.P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. (forthcoming June 2007) (manuscript at 7-8 n.21, on file with the North Carolina Law Review) ("Prior to [Sarbanes-Oxley], grants meeting certain requirements could be reported . . . within 45 days after the end of the company's fiscal year."). Sarbanes-Oxley, however, instituted a real-time disclosure requirement for option awards, and shortly after the Act's passage, the SEC promulgated new regulations requiring that directors and officers disclose options within two business days of the award. *See* 15 U.S.C. § 78p(a)(2)(C); Cox, *supra* note 13, at 3 (addressing the impact of Sarbanes-Oxley on abusive option practices).

59. ALLEN & MISHRA, *supra* note 5, at 2; Chauvin & Shenoy, *supra* note 55, at 53-76; Yermack, *supra* note 55, at 449-76.

60. Lie, *supra* note 42, at 802.

abnormally low stock prices just prior to the granting of stock options, and unusually high stock prices during the time period immediately following a grant package.⁶¹ Notably, the Lie study recognized “a sharp decline in prices immediately before unscheduled and unclassified awards followed by a sharp reversal immediately afterwards.”⁶² Lie posited 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.”⁶³ The results of Professor Lie’s study were groundbreaking and unleashed a firestorm of controversy in the investment community.⁶⁴

Even prior to these contemporary studies regarding the option timing practices of many corporations, the SEC had investigated several isolated cases⁶⁵ of backdating option grants.⁶⁶ Professor Lie’s study, however, was the first indication of a more prolific backdating phenomenon.⁶⁷ Professor Lie estimated that nearly ten percent of all stock options granted prior to August of 2002 are tainted by the

61. *See id.* at 810–11.

62. *Id.* at 807.

63. *Id.* at 811. Ultimately,

[t]his prompts the question as to whether some of the awards are timed ex post facto. That is, when the decision regarding the official award date is made, the official award date (and, hence, the exercise price of the options) might be determined to be an *earlier* date that had a particularly low price.

Id. at 807.

64. *See supra* note 25 and accompanying text (discussing recent controversies over backdating).

65. In November 2005, for example, Mercury Interactive announced the resignation of three top executives in the wake of investigations that uncovered forty-nine instances of backdating and manipulating equity option grants. Rebecca Buckman et al., *Mercury Interactive Executives Resign in Wake of Probe*, WALL ST. J., Nov. 2, 2005, at A7; *see also* Cox, *supra* note 13, at 5–7 (noting several companies that the SEC has investigated). Around that same time, executives from Analog Devices agreed to settle a civil suit regarding allegations of timing irregularities in granting stock option awards. *See* Press Release, Analog Devices, Analog Devices Announces Tentative Settlement of the SEC’s Previously Announced Stock Option Investigation (Nov. 15, 2005), *available at* http://www.analog.com/en/press/0,2890,3__88325,00.html (discussing the elements of the settlement whereby the company would “consent to a cease-and-desist order under Section 10(b) of the Securities Exchange Act and Rule 10b-5 [and] thereunder, would pay a civil money penalty of \$3 million, and would reprice options granted to Mr. Fishman and other directors in certain years”).

66. *See generally* Geoffrey Colvin, *A Study in CEO Greed: How One Intrepid Academic Exposed the Latest Stock Option Scandal*, FORTUNE, June 12, 2006, at 53 (discussing the isolated SEC investigations that occurred prior to Professor Lie’s study).

67. *See id.*

specter of potential backdating,⁶⁸ and Merrill Lynch has released a similar report⁶⁹ which surmises that forty companies in the S&P 500 manipulated the timing of option grants between 1999 and 2002.⁷⁰

At the outset of the backdating scandal, questionable option timing practices appeared to be concentrated largely in the technology sector and among smaller companies with significant stock price volatility.⁷¹ However, more recent revelations indicate that the backdating scandal may be far more pervasive, especially as large-cap, blue-chip companies announce impending investigations into their option timing practices.⁷² Initial estimates surmise that twenty-three percent of “unscheduled, at-the-money grants to top executives dated between 1996 and August 2002 were backdated or otherwise manipulated.”⁷³ Moreover, nearly thirty percent of all firms granting equity options to executives between 1996 and 2005 are thought to have manipulated their grants in some fashion.⁷⁴ At least sixty companies have already acknowledged SEC or Justice Department investigations into their option practices,⁷⁵ and the SEC itself claims to have at least 100 companies under regulatory scrutiny.⁷⁶ In corporate boardrooms, the numbers continue to climb, with eighteen CEOs forced into resignation, over five billion dollars in corporate profits restated, and five indictments levied against executives from Brocade Communications Systems, Inc. and Comverse Technology,

68. ALLEN & MISHRA, *supra* note 5, at 3; Lie, *supra* note 42, at 802.

69. MERRILL LYNCH, QUANTITATIVE STRATEGY UPDATE: OPTIONS PRICING FOR THE S&P 500 (2006) (on file with the North Carolina Law Review).

70. ALLEN & MISHRA, *supra* note 5, at 3.

71. Erik Lie, Backdating of Executive Stock Option Grants, <http://www.biz.uiowa.edu/faculty/elie/backdating.htm> (last visited Apr. 4, 2007).

72. After announcing impending investigations into the company's option timing practices, Apple reported that internal investigations had uncovered timing irregularities with at least fifteen option grants between 1997 and 2002, sparking a wave of derivative actions, public apologies from CEO Steve Jobs, and the forced resignation of CFO Fred Anderson. See Press Release, Apple Inc., Apple's Special Committee Reports Findings of Stock Option Investigation (Oct. 4, 2006), <http://apple.com/pr/library/2006/oct/04/investigation.html>. Other companies, such as healthcare magnate Caremark Rx, Inc., have taken a different approach, publicly denying allegations of improper backdating despite the ominous presence of pending regulatory and criminal investigations. Erik Schelzig, CEO: Caremark 'OK' in SEC Investigation, BOSTON.COM, Sept. 21, 2006, http://www.boston.com/business/technology/articles/2006/09/21/ceo_caremark_ok_in_sec_investigation. For an exhaustive tabular summary of companies currently embroiled in the backdating scandal, see Wong, *supra* note 25.

73. Lie, *supra* note 71.

74. See *id.*

75. SEC Adopts New Regulations, *supra* note 21.

76. Cox, *supra* note 13, at 7.

Inc.⁷⁷ Although experts and commentators agree that the option backdating scandal is prolific among publicly traded companies,⁷⁸ the true scope of the scandal remains to be seen.⁷⁹

In January of 2006, the SEC began to address the increasing concerns of the investment and shareholder communities by unveiling a new cache of proposed compensation disclosure rules aimed at improving transparency and ensuring the proper use of corporate assets.⁸⁰ But the optimism that followed the SEC's January proposals quickly faded when *The Wall Street Journal* published a scathing article questioning the wildly improbable grant patterns of several prominent companies.⁸¹ As the number of companies under scrutiny continued to grow, the investment community became increasingly adamant about the need for tighter SEC regulation.⁸² While events unfolded on Wall Street, large institutional investors⁸³ and activist shareholders began to lobby the SEC to include specific provisions in the proposed executive compensation disclosure rules that would address abusive backdating practices.⁸⁴ Assuaging the concerns of these investors, the SEC vowed to address backdating and other option timing issues when it adopted its final executive compensation disclosure rules.⁸⁵

77. Marcy Gordon, *Stock Option Scandal Will Go on in '07*, YAHOO NEWS, Dec. 11, 2006, http://biz.yahoo.com/ap/061211/ye_stock_options_companies.html?.v=1.

78. See *supra* notes 65–77 and accompanying text.

79. Paul J. McNulty, Deputy Attorney Gen., Dep't of Justice, Executive Compensation: Backdating to the Future, Oversight of Current Issues Regarding Executive Compensation Including Backdating of Stock Options; Tax Treatment of Executive Compensation, Retirement and Benefits: Remarks Before the Committee on Finance, United States Senate 8 (Sept. 6, 2006), <http://finance.senate.gov/hearings/testimony/2005test/090606testpm.pdf> (“[W]e cannot say at this juncture how many cases we will ultimately investigate or what number will be more appropriately resolved as criminal, rather than as civil matters.”).

80. ALLEN & MISHRA, *supra* note 5, at 1.

81. Charles Forelle & James Bandler, *The Perfect Payday*, WALL ST. J., Mar. 18, 2006, at A1. The subsequent wave of media and shareholder scrutiny sent investors and market observers “scrambling to identify companies with suspicious grant patterns, leading to a rash of internal investigations, shareholder lawsuits, and, most ominously, criminal probes by the Department of Justice.” Mark A. Borges & Amy M. Knieriem, Mercer Human Res. Consulting, *New SEC Disclosure Rules Put Spotlight on Options Practices* (Aug. 1, 2006), <http://www.mercerhr.com/referencecontent.jhtml?idContent=1236340>.

82. ALLEN & MISHRA, *supra* note 5, at 1.

83. Most outspoken in their efforts were the Council of Institutional Investors, CalPERS, the New York City Pension Funds, and the Connecticut Retirement Plans and Trust Funds. Borges & Knieriem, *supra* note 81.

84. See *id.*

85. See *id.*

In July 2006, the SEC carried forth with its promise when it adopted the final version of the new executive compensation disclosure rules.⁸⁶ The new rules are intended to remedy deficiencies in the existing regulatory regime⁸⁷ of equity option grants by explicitly requiring line-item disclosure of grant dates, exercise prices, and rationales surrounding the determination of stock option timing patterns.⁸⁸ The backdating provisions of the new regulations consist of two fundamental components: tabular disclosure of backdated options⁸⁹ and narrative discussion of executive option plans.⁹⁰

The new tabular disclosure requirements mandate that option grants be disclosed in a summary compensation table designed to provide shareholders with a more accurate assessment of the value of executive option packages at the time the options are issued.⁹¹ These tabular disclosures will include the date on which the option grant is awarded,⁹² presumably creating a deterrent to abusive backdating practices.⁹³ Moreover, in cases where the exercise price of a particular grant is less than the fair market value of the underlying security, the new regulations require that companies create a separate, adjoining column on the summary compensation table that

86. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 228, 229, 232, 239, 240, 245, 249, 274).

87. Existing securities laws prohibit publicly traded companies from making material misrepresentations of stock option grant dates. Moreover, SEC regulations require that companies disclose any material information that might further clarify, or prevent misunderstandings of other disclosures. See 17 C.F.R. § 240.12b-20 (2006).

88. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,163–64.

89. *Id.* at 53,163 (“As proposed and adopted, grants of stock options will be disclosed in the Summary Compensation Table at their fair value on the date of the grant.”).

90. See *id.* at 53,162–63 (“Companies will also be required to address matters relating to executives’ option compensation in the new Compensation Discussion and Analysis section, particularly as they relate to the timing and pricing of stock option grants.”). For a highly generalized discussion of each of the components, see HAMILTON, *supra* note 36, at 80.

91. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,163 (noting that the disclosure of option grants in a summary compensation table “will give shareholders an accurate picture of the value of options at the time they are actually granted to the highest-paid executive officers”).

92. *Id.* (“A separate table including disclosure of equity awards . . . requires disclosure of the grant date . . . [which] is generally considered the day the decision is made to award the option as long as recipients of the award are notified promptly.”). Even in cases where the exercise price of the grant is tied to the fair market value of an earlier date, the actual grant date does not change. See *id.*

93. *Id.* at 53,162 (“The Commission acknowledged the importance to investors of proper disclosure of executives’ option compensation throughout the Proposing Release The disclosure we proposed in January, along with related disclosure we also adopt today, should provide investors with more information about option compensation.”).

would indicate the fair market value of the security on the date the grant was issued.⁹⁴ These summary compensation tables are considered by the SEC to be the primary means of disclosure with regards to executive pay packages.⁹⁵ Through these tabular disclosure requirements, the SEC intends to facilitate shareholder understanding of “the extent and magnitude to which an executive’s previously awarded options provide the potential to generate upside growth in the value” of the underlying security.⁹⁶

Aside from tabular disclosure requirements, “[c]ompanies will also be required to address matters relating to executives’ option compensation in the new Compensation Discussion and Analysis section, particularly as they relate to the timing and pricing of stock option grants.”⁹⁷ As part of the new regulations, the SEC has provided a nonexhaustive list of queries that might be addressed in a company’s disclosures.⁹⁸ For example, companies choosing to award stock options with an exercise price below that of the security’s fair market value on the grant date might be required to disclose the

94. *Id.* at 53,163 (“If the exercise price is less than the closing market price of the underlying security on the date of the grant, a separate, adjoining column would have to be added to this table showing that market price on the date of the grant.”). In the event that the date of the option grant differs from the date on which the compensation committee or board of directors actually granted the options, then a separate adjoining column would be added that states the date on which the committee or board actually granted the option award. *See id.* Moreover, in the event that the exercise or strike price of a particular grant is not the same as the market price of the underlying security on the day of the grant, then the new tabular disclosure requirements require a description of the methodology the committee or board use to ascertain the price at which the option could be exercised. *See id.*

95. HAMILTON, *supra* note 36, at 17 (recognizing that prior SEC rules “permitted the omission of too much information,” whereas the new summary compensation tables are intended as “the principal disclosure vehicle for executive compensation”).

96. *Id.* at 18.

97. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,163. The regulation also requires that,

[i]f the company had since the beginning of the last fiscal year, or intends to have during the current fiscal year, a program, plan or practice to select option grant dates for executive officers in coordination with the release of material non-public information, the company should disclose that in the Compensation Discussion and Analysis section.

Id.

98. *See id.* at 53,164. For example, companies may be required to explain why stock option grants are awarded on particular dates and what methods the company uses in selecting the terms and exercise price of executive option awards. *See* HAMILTON, *supra* note 36, at 81.

rationale employed in determining the exercise price.⁹⁹ The SEC's examples of proper disclosure clearly emphasize the necessity of disclosing any material information relating to the timing of stock option grants.¹⁰⁰ Recognizing that "some companies may have a program . . . of awarding options . . . based on the stock's price on a date other than the actual grant date,"¹⁰¹ the SEC clarifies that such a program would require absolute disclosure, both in the Executive Compensation Summary Table and in the section dedicated to Compensation Discussion and Analysis.¹⁰² For other matters however, the nonexhaustive nature of the SEC's generalized examples of proper disclosure ultimately leave companies to consider their own facts and circumstances in determining the breadth of their new disclosure obligations.¹⁰³

SEC Chairman Christopher Cox expects that these new regulations will require new disclosures "to be written in plain English so every investor can understand" the compensation schemes being utilized.¹⁰⁴ And while the overriding objective of these regulations is to make executive compensation understandable to the company's shareholders,¹⁰⁵ the enhanced disclosure requirements will

99. See Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,164 ("How does a program, plan or practice to time option grants to executives fit in the context of the company's program, plan or practice, if any, with regard to option grants to employees more generally?"). The SEC has provided several examples of the type of information that companies might address in the Compensation Discussion and Analysis section. For example, Item 402(b)(2)(iv) pertains to the method by which companies determine the date of executive option grants. This particular provision was "included in part to note that material information to be disclosed under Compensation Discussion and Analysis may include the reasons a company selects particular grant dates" for stock option awards. *Id.* at 53,163.

100. See *id.* (requiring the disclosure of compensation information "particularly as [it] relate[s] to the timing and pricing of stock option grants" (emphasis added)); HAMILTON, *supra* note 36, at 81-82.

101. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,164.

102. *Id.* ("Such a program, plan or practice would . . . require disclosure, including, as appropriate, in the tables . . . and in the Compensation Discussion and Analysis section. Again . . . companies should consider their own facts and circumstances and include all relevant material information in their corresponding disclosures."); HAMILTON, *supra* note 36, at 83.

103. See Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,163.

104. ALLEN & MISHRA, *supra* note 5, at 6 (quoting Chairman Cox); Cox, *supra* note 13, at 4; see Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,208 ("We are adopting as proposed a requirement that most of the disclosure . . . be provided in plain English.").

105. Cox, *supra* note 13, at 2; Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,159 ("The amendments to the compensation disclosure rules are

force companies to “make it clear whenever options are being backdated, and . . . will require an explanation of the reasons” for granting an option below fair market value.¹⁰⁶ By requiring both quantitative and narrative disclosure of stock option components in executive compensation packages, the new prophylactic disclosure rules will virtually eviscerate abusive backdating practices.¹⁰⁷ Some believe that the new disclosure requirements with regard to backdated options will “effectively slam[] the door shut on the easy opportunities to get away with secretive option grants.”¹⁰⁸

The praise levied by Chairman Cox represents only a small sampling of the tremendously positive reception that the SEC has garnered from the investment community with regard to the new backdating disclosure provisions of the executive compensation disclosure rules.¹⁰⁹ In fact, one would be hard pressed to discern any mainstream criticism specific to the backdating disclosure provisions. Despite the popular praise, however, there has been only minimal discussion of whether the new backdating disclosure provisions represent any meaningful departure from existing securities laws or whether the provisions can successfully quell the abusive option timing practices prevalent in corporate America. Although the backdating provisions in the new rules mark an admirable attempt by

intended to provide investors with a clearer and more complete picture of compensation to principal executive officers.”).

106. Presumably, the Compensation Analysis and Discussion Section will include information pertaining to various rationales for backdated options along with disclosures regarding the role of management and other executives in determining the amount of compensation. *See* Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,159.

107. *See* Cox, *supra* note 13, at 4.

108. *Id.* Outside of the SEC and other federal regulatory bodies, private trade groups and business consulting entities have also heaped tremendous praise on the effectiveness of the new disclosure rules. *See, e.g.,* O'Hara, *supra* note 16 (explaining that one large trade group, in particular, would be extremely pleased with the new regulations despite having voiced some concern when the initial rule proposal was released last January); Kathleen Pender, *Stricter Rules on Compensation Disclosure Adopted*, S.F. CHRON., July 27, 2006, at C1 (citing the extraordinarily positive commentary on the new disclosure rules from attorneys, institutional investors, and market analysts).

109. *But see* Narayanan et al., *supra* note 58 (manuscript at 4) (noting that the “misdating of option grants has legal, economic, tax, and governance implications all of which are detrimental to shareholders). In this Article, the authors address the economic impact of backdated equity option grants. Although the authors' thesis does not specifically deal with the propriety of the new disclosure regulations, the authors do appear to criticize the disclosure rules for various deficiencies. *See id.* (“Disclosure of misdating practices can lead to restatement of earnings as the camouflaged pay is recognized as compensation expense. The reduced earnings can result in a downward reassessment of shareholder value.”).

federal regulators to address public fury over the options backdating scandal, the new requirements merely reaffirm existing disclosure provisions already contained in the federal securities laws. Moreover, by regulating only the *disclosure* of backdated options,¹¹⁰ the SEC appears to have sanctioned the actual *practice* of backdating stock options—a practice which many commentators contend is unethical at best and illegal at worst.¹¹¹

Prior to the new executive compensation disclosure rules, the practice of issuing undisclosed backdated option grants was illegal and violated federal securities law.¹¹² Section 10(b) of the Securities and Exchange Act of 1934 (“the 1934 Act”) broadly prohibits publicly traded companies from making misleading statements or omitting material information in their public disclosures.¹¹³ Moreover, Rules 12b-20,¹¹⁴ 13a-1,¹¹⁵ and 13a-11,¹¹⁶ all promulgated by the SEC pursuant

110. See Paul S. Atkins, Comm’r, Sec. & Exch. Comm’n, Remarks at the SEC Open Meeting (July 26, 2006), <http://www.sec.gov/news/Speech/2006/spch072606psa.htm>. According to Commissioner Atkins,

It is important that we provide investors with complete and clear disclosure about compensation, regardless of the form that compensation takes Thus, in adopting clear disclosure guidance for options today, we are not telling companies to use or not to use options or to dispense them in a particular way. We are simply providing what we hope to be clear guidelines for disclosure in an area that may not have had clear enough guidelines in the past.

Id.

111. For a more generalized discussion of the legality of backdating option grants, see *infra* notes 112–35 and accompanying text.

112. See Narayanan et al., *supra* note 58 (manuscript at 13); see also John W. Schoen, *Corporate Fraud Alive and Well in U.S.: Despite Enron Verdict, Accounting Reforms, White Collar Crime Thriving*, MSNBC, May 25, 2006, <http://www.msnbc.msn.com/id/1276573> (explaining that federal authorities were in the process of investigating backdated options that were granted to certain corporate executives well before the enactment of the new executive compensation disclosure rules); Colvin, *supra* note 66, at 53 (noting that even though backdating option grants may be legal in theory, as practiced, backdating is “stealing, pure and simple” because “following the complicated rules would largely eliminate the advantages” of backdating options in the first place).

113. See 17 C.F.R. § 240.10b-5 (2006) (stating that it shall be unlawful “[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading”).

114. See § 240.12b-20 (“In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.”).

115. See § 240.13a-1 (“Every issuer . . . shall file an annual report on the appropriate form authorized or prescribed therefore for each fiscal year after the last full fiscal year for which financial statements were filed in its registration statement.”).

to their authority under the 1934 Act, contain similar provisions requiring the full disclosure of any material information.¹¹⁷ Although courts have not yet been afforded the specific opportunity to address the legality of various option timing schemes,¹¹⁸ the failure to disclose backdated equity option packages appears certain to create material inaccuracies in a company's public statements regarding their executive compensation practices.¹¹⁹ Moreover, the fact that a backdated option allows a company's executive to enjoy an undisclosed financial windfall—while causing shareholders to incur an unintended compensation expense—would be considered a material fact that a company would have been required to publicly disclose even before the promulgation of the new disclosure rules.¹²⁰

116. See § 240.13a-11 (“[E]very registrant . . . shall file a current report on Form 8-K within the period specified in that form, unless substantially the same information as that required by Form 8-K has been previously reported by the registrant.”).

117. David H. Kistenbroker, *Back-Dating Stock Options: An Overview*, in STOCK OPTION PRICING PRACTICES: WHAT YOU NEED TO KNOW, *supra* note 55, at 83, 88. Although there is no rigid formulation “for determining what information is ‘material’ . . . a good guideline is whether or not a reasonable investor would attach significance to the information in making an investment decision.” BARTOS, *supra* note 14, at 210; *see also* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (holding that the materiality of information depends upon whether a plaintiff can establish “a substantial likelihood that a reasonable shareholder would consider it important”). For an additional discussion of “materiality” in terms of corporate disclosures, *see* HAZEN, *supra* note 14, at 487–89.

118. One federal district court has had the opportunity to address option backdating in the specific context of an initial public offering and determined that a failure to disclose backdated equity option grants constituted a material omission. *See* Primavera Investors v. Liquidmetal Techs., Inc., 403 F. Supp. 2d 1151, 1157 (M.D. Fla. 2005). In the SEC's enforcement action against Brocade Communications, the Commission has urged the court to allow relief pursuant to § 10(b) of the 1934 Act. *See* Complaint at ¶ 68–70, SEC v. Reyes, No. 06–CV–4435 (N.D. Calif., July 20, 2006) (“By engaging in the conduct described above, [the defendants] . . . (a) employed devices, schemes, or artifices to defraud; (b) made untrue statements of a material fact or omitted to state a material fact . . . and (c) engaged in acts, practices, or courses of business which operated or would operate as a fraud or deceit upon other persons.”).

119. Bruce G. Vanyo & Michael S. Weisman, *Back-Dating Stock Options: An Overview*, in SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2006, at 623, 627–32 (Practicing Law Inst. ed., 2006); *see also* Paul H. Dawes & Kory Sorrell, *Tools for the Imperfect Instrument: Practical Advice for Investigating Stock Option Awards*, in SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2006, *supra*, 641, 647 (contending that undisclosed backdating may result in misleading public disclosures and SEC filings).

120. Vanyo & Weisman, *supra* note 119, at 626; *see also* Narayanan et al., *supra* note 58 (manuscript at 18) (“Even by very crude quantitative materiality benchmarks . . . misstated earnings would likely be material.”); Kistenbroker, *supra* note 117, at 91 (“The fact that the back-dating practice enabled the executive to enjoy an immediate paper gain, while causing the issuer to incur a compensation-related expense, may be deemed a material feature of the plan that a reasonable shareholder or investor would consider important to an investment decision.”).

In its initial prosecution efforts, the Justice Department has adopted a strikingly similar rationale, adamantly decrying the illegality of surreptitious backdating practices, notwithstanding the new SEC disclosure rules.¹²¹ Fraudulent conduct involving option timing practices is already being prosecuted under the criminal provisions of the Sarbanes-Oxley Act,¹²² specifically those provisions pertaining to securities fraud,¹²³ the certification of false statements filed with the SEC,¹²⁴ altering records subject to a federal investigation,¹²⁵ and the destruction of corporate audit records.¹²⁶ Deputy Attorney General Paul McNulty, staking out the Justice Department's position before the Senate Finance Committee, contended that backdating practices invariably give rise to "false and misleading reports and financial statements" and the subsequent dissemination of "false and fraudulent information to the investing public."¹²⁷ Even in cases where executive option plans have been approved by shareholders, the failure to specifically report backdated options "misrepresents the true nature of stock option plans and executive compensation and thus, a company obtains shareholder approval . . . under false pretenses."¹²⁸ Some have even contended that backdating option grants is tantamount to the unlawful embezzlement of corporate assets.¹²⁹

Ironically, even the SEC itself appears to have acknowledged the illegality of undisclosed backdated options long before the enactment of its most recent disclosure rules.¹³⁰ In the enforcement action

121. See McNulty, *supra* note 79, at 8 ("The practice of stock option backdating . . . can only be seen as a brazen abuse of corporate power to artificially inflate the salaries of corporate wrongdoers at the expense of shareholders. By fraudulently backdating grants, defendants evade significant accounting, disclosure and tax requirements . . .").

122. *Id.* However, some backdating practices may have predated the implementation of Sarbanes-Oxley, in which case the Justice Department would have to rely on preexisting securities laws. See *id.*

123. See 18 U.S.C. § 1348 (2000 & Supp. IV 2004).

124. See *id.* § 1350.

125. See *id.* § 1519.

126. See *id.* § 1520.

127. McNulty, *supra* note 79, at 3 (noting, as well, that existing federal securities laws require corporations to accurately report executive compensation packages and accurately describe the option plans for which they are seeking shareholder approval).

128. *Id.*

129. See *id.* at 3-4 ("Grants of backdated options contrary to the terms of shareholder-approved option compensation plans can also be considered an embezzlement of corporate assets because the defendants are misappropriating shares of the company at an unauthorized and discounted value.").

130. See Complaint at 1, SEC v. Alexander, No. 06-CV-3844 (E.D.N.Y. Aug. 9, 2006); see also Kistenbroker, *supra* note 117, at 99 ("The disclosure and accounting issues raised

against Comverse Technology, for example, the SEC claimed that the backdating practices of top executives violated numerous provisions of the Securities Act of 1933 and the Securities and Exchange Act of 1934.¹³¹ The SEC levied similar charges against Symbol Technologies in 2004, alleging a litany of securities fraud violations after the company was found to have ignored accepted protocols in accounting for executive option grants.¹³² According to the SEC's complaint, the company's improper backdating practices led to the misstatement of earnings and improper reductions in the company's corporate tax liability.¹³³ In short, backdated option grants "by their nature . . . fall within the parameters of the current standards for material misrepresentation."¹³⁴ Consequently, the SEC's most recent efforts at ensuring the disclosure of backdated options serve only as a restatement of existing requirements that have been in place since the passage of the 1933 and 1934 Securities Acts.¹³⁵

Despite the fact that the new disclosure rules fail to represent any meaningful departure from the existing disclosure regime that would prohibit undisclosed backdated options, the potential ramifications of the new SEC rules cannot be overstated. In promulgating this "new" disclosure regime, the SEC declined to comment on whether a company may have a valid business interest in backdating option grants.¹³⁶ Instead, the SEC continued to rely on

by back-dating have already provided the bases for securities litigation filed against issuers and executives.").

131. See Complaint at ¶ 3–5, SEC v. Reyes, No. 06–CV–4435 (N.D. Calif. July 20, 2006) ("By falsifying the dates on which options were purportedly granted . . . the defendants, among other things, violated the antifraud provisions of the federal securities laws, falsified books and records, and caused Brocade to falsely report its financial results.").

132. Thomsen, *supra* note 41, at 4 (statement of Linda Thomsen, Director, Division of Enforcement, Securities and Exchange Commission) ("The complaint alleged that rather than use the actual exercise date as defined by Symbol's option plans, [certain executives] instituted, without board approval or public disclosure, a practice of using a more advantageous date chosen from a 30-day 'look-back' period so as to reduce the cost of the exercise to the executive.").

133. *Id.* at 4–5. The Department of Justice also commenced parallel criminal proceedings against Symbol Technologies as well as their General Counsel, Leonard Goldner. The criminal charges alleged that certain executives violated securities fraud statutes through the practice of backdating equity option grants. *Id.*

134. Narayanan et al., *supra* note 58 (manuscript at 16).

135. See *id.*

136. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,163 (Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 228, 229, 232, 239, 240, 245, 249, 274) ("The Commission does not express a view as to whether or not a company may or may not have valid and sufficient reasons for such timing of option grants, consistent with a company's own business purposes.").

principle-based disclosure, allowing companies to “consider their own facts and circumstances . . . in their corresponding disclosures.”¹³⁷ However, by failing to take a position on the practice of backdating option grants, the SEC appears to have given its tacit acceptance of this abusive and deceptive practice.

John Coffee, a renowned professor of securities law at Columbia University, has argued that “[b]ackdating is clearly a badge of fraud.”¹³⁸ Indeed, there is compelling evidence that backdating option grants, regardless of any disclosures, violates both state and federal securities law.¹³⁹ Alan Dye, a securities expert at the law firm of Hogan & Hartson, believes that misleading disclosures pertaining to options backdating would constitute securities fraud, and that companies failing to properly disclose backdated options will often encounter a litany of accounting and taxation violations.¹⁴⁰ As practiced, backdating equity option grants is analytically indistinguishable from the more ingenious, yet equally destructive, tactics that were used to pillage the corporate coffers at Enron, WorldCom, and Tyco.¹⁴¹

Within the SEC, however, there appears to be no consensus regarding the legality of backdating, which would explain why the new regulations require merely the disclosure of backdated options, as opposed to providing for a blanket prohibition of the practice.¹⁴² Former SEC Commissioner Cynthia Glassman recently stated her belief that backdating options is “clearly illegal.”¹⁴³ Commissioner Paul Atkins, on the other hand, was more conciliatory, noting that “the mere fact that options were backdated does not mean that the securities laws were violated.”¹⁴⁴ Instead, Commissioner Atkins attributes the current backdating scandal to the lack of clear guidelines¹⁴⁵ that were available to companies regarding their disclosure obligations in this particular area.¹⁴⁶

137. *Id.*

138. Vineeta Anandand & Laurence Arnold, *Taking the Heat for Stock Options: Executive Grants Under Investigation*, INT’L HERALD TRIB., May 26, 2006, at 21 (quoting John Coffee of Columbia University).

139. Narayanan et al., *supra* note 58 (manuscript at 13).

140. Mark Maremont, *Authorities Probe Improper Backdating of Options*, WALL ST. J., Nov. 11, 2005, at A4 (addressing the various legal issues generally arising from improper backdating procedures).

141. Colvin, *supra* note 66, at 53.

142. Vinson & Elkins LLP, *supra* note 52.

143. *Id.*

144. *Id.*

145. Although the SEC attempted to clarify benefit disclosure policy through the promulgation of the 1992 disclosure rules, shareholders and institutional investors

While backdating practices are almost uniformly regarded as ethically questionable, most commentators agree that the legality of a company's actions will almost always turn on the manner in which the company issued the options.¹⁴⁷ Generally, the practice of backdating equity option grants does not give rise to criminal culpability¹⁴⁸ so long as the backdated options are clearly communicated to corporate shareholders and the costs of the backdated options are accurately reflected in corporate earnings¹⁴⁹ and tax returns.¹⁵⁰ Perhaps it was this technical and largely abstract "legality" that was a contributing factor in the SEC's decision to regulate only the disclosure of backdated options as opposed to instituting an outright prohibition of the practice. Unsurprisingly, however, the conditions under which backdating may be legal are rarely satisfied.¹⁵¹ Adhering to the rules above would eviscerate any potential benefit that a corporation might perceive from backdating option grants in the first place. In fact, "if

continued to complain of the "incomprehensible" reporting of executive pay packages even after the SEC's attempts at comprehensive reform. See Nathan Knutt, *Executive Compensation Regulation: Corporate America, Heal Thyself*, 47 ARIZ. L. REV. 493, 500 (2005).

146. Vinson & Elkins LLP, *supra* note 52.

147. Amanda Cantrell, *More Than 100 Firms Probably Backdated Options*, CNN MONEY, July 12, 2006, http://money.cnn.com/2006/07/12/technology/options_saga/index.htm.

148. Vinson & Elkins LLP, *supra* note 52 ("[T]he mere fact that options were backdated does not mean that the securities laws were violated."). The SEC and the Department of Justice have committed to examining backdating cases on an individual basis, challenging only those cases where corporate executives have been the beneficiaries of slumping stock prices because of the retroactive timing of equity option grants. See *id.* The decision to commence criminal or civil enforcement proceedings will depend primarily on the corporation's disclosure of its option timing practices and whether the company's accounting recognized the costs of these in-the-money option grants on corporate earnings statements. See *id.*

149. The granting of backdated options is financially tantamount to the popular practice of granting in-the-money options, and consequently, the reported earnings for the fiscal year of the backdated option grants should be reduced commensurate with the corporation's cost of issuing the options. Many companies have recently restated earnings from past years as a result of their earlier failures to properly account for the backdated grants. See Lie, *supra* note 71.

150. The exercise price of an equity option grant directly affects corporate compensation expenses that are used for tax purposes, and also the capital gains taxes for the recipient of the grant. Hence, a backdated option may alter the tax liability for both the corporation and the executive alike. See *id.* For a specific discussion of the individual tax consequences for executives receiving backdated option grants, see Mark Everson, Comm'r of Internal Revenue, Internal Revenue Serv., *Backdating of Stock Options and Other Executive Compensation Issues: Remarks Before the Committee on Finance, United States Senate 4-8* (Sept. 6, 2006), <http://finance.senate.gov/hearings/testimony/2005test/090606testme.pdf>. For a more general discussion regarding the legality of option backdating, see McNulty, *supra* note 79, at 4-8.

151. Lie, *supra* note 42, at 804.

these conditions hold, there is little reason to backdating options, because the firm can simply grant in-the-money options instead.”¹⁵²

The backdating provisions of the executive compensation disclosure rules also fail to address many of the fundamental circumstances that give rise to backdated option grants in the first place. Professor Lie contends that the abusive backdating of option grants occurs, at least in part, because most equity option plans do not explicitly prohibit the species of manipulation that comes with backdating option grants.¹⁵³ Although option plans generally mandate that the exercise price be equal to the market price of the security on the day of the award,¹⁵⁴ these plans do not expressly prohibit the grant date from preceding the date of the award. Even in the wake of the executive compensation disclosure rules, company option plans will still tacitly permit the backdating of option plans, albeit with slightly more public disclosure. When combined with the SEC’s tacit acceptance of option backdating in the new disclosure rules, executives may find themselves in a better position than ever before to manipulate the timing of equity option grants.

Admittedly, the new backdating disclosure rules promulgated by the SEC are a step in the right direction, if for no other reason than the increased awareness of backdating practices that accompanied the passage of the new disclosure rules.¹⁵⁵ However, the SEC should have prohibited the deceptive practice altogether. Indeed, it is nearly impossible to successfully advocate for the right of corporate executives to retroactively backdate option grants at lower stock prices, especially when other less deceptive means are readily available to achieve the very same objectives.¹⁵⁶ Instead of

152. *Id.*

153. *See id.* at 807.

154. *See id.*

155. Professor Erik Lie, though supportive of the newest SEC executive compensation disclosure rules, contends that abusive option practices will be greatly curtailed if for any other reason than “‘because of the media focus and the consequences the companies face.’” Pender, *supra* note 108. Previously, Lie believed that corporate executives were simply “‘thinking they would get away with [backdating]. Now they’re recognizing they won’t get away with it.’” *Id.*

156. *See Lie, supra* note 42, at 804 (contending that corporate executives could realize all the benefits of backdated options, except for nondisclosure, by simply increasing “the value of the award by either awarding more options or awarding options with an exercise price lower than the market price at the award date [i.e. discounted stock options]”). However, Paul Dorf, the managing director at Compensation Resources, Inc., offers several explanations for why corporations are hesitant to issue larger option grants or discounted options in lieu of engaging in deceptive backdating:

backdating options, a corporation might just as easily increase the value of an equity option award simply by granting traditional discounted stock options. Indeed, it is difficult to discern any *legitimate* benefit to backdating options that cannot be likewise obtained from granting less deceptive, discounted stock options.

Ever since the promulgation of comprehensive federal securities laws in the early 1930s,¹⁵⁷ the SEC has largely adhered to a strict disclosure-based regime,¹⁵⁸ whereby publicly traded companies are required to disclose material information.¹⁵⁹ In similar fashion,

First, the number of options awarded is often determined by past awards and/or industry norms. Second, the stock option plan limits the number of options that can be awarded. Third, stockholders dislike the potential dilutive effect generated by a large number of outstanding options. Fourth, accounting rules require a charge to earnings for grants that are issued in-the-money. Fifth, stockholders are averse to the notion of issuing options “at a discount” to executives.

Id. at 804. Despite these plausible explanations, the detriments associated with issuing discounted options pale in comparison to the potential liability that shareholders face when executives choose to backdate their option awards.

157. The federal regulation of securities began as a response to the stock market crash of 1929. See Jonathan Z. Cohen, *The Mellon Bank Order: An Unjustifiable Expansion of Banking Powers*, 8 ADMIN. L.J. AM. U. 335, 336 (1994). Prior to the enactment of these regulations, American financial institutions were awash in corruption and disarray. See Jon Canfield, *The Evolution of a More Stringent Business Judgment Rule in Banking—The Minimalization of Director Deference*, 6 U.C. DAVIS BUS. L.J. 153, 160 (2006). Adverse economic conditions and rampant speculation led to the demise of more than 9000 commercial banks by 1933, at which point Congress undertook two comprehensive legislative efforts aimed at restoring order to American capital markets. See *id.* The Securities Act of 1933 and the Securities Exchange Act of 1934 continue to represent the primary governing body of federal regulatory authority pertaining to the issuing and sale of publicly traded securities. See Securities Act of 1933, 15 U.S.C. § 77a (2000); Securities Exchange Act of 1934, 15 U.S.C. § 78a (2000). The 1933 Act has been characterized as the first consumer protection law implemented by Congress and is generally thought to have been “a great success in balancing the needs of investors and the public generally against the desire to maintain free and efficient markets.” HAZEN, *supra* note 14, at 21–22. The 1934 Act is significantly broader in scope than the 1933 Act and governs the everyday transactions in capital markets. For a highly comprehensive discussion of the 1934 Act, see *id.* at 326–57.

158. The disclosure regime has its origins in English corporate law and was adopted in the United States with the passage of the 1933 and 1934 Acts, which promoted the public disclosure of material information with respect to companies that traded securities on the capital market. See JIM BARTOS, UNITED STATES SECURITIES LAW: A PRACTICAL GUIDE 2 (2d ed. 2002). However, federal securities laws have always maintained at least some component of substantive rulemaking that prohibits certain corporate governance practices. For example, the Foreign Corrupt Practices Act contains antibribery provisions as well as certain record-keeping requirements that publicly traded corporations are required to follow. See *id.* at 196–97.

159. See Jason Michael Craft, *What’s All the Commotion?: An Examination of the Securities and Exchange Commission’s Regulation FD*, 14 DEPAUL BUS. L.J. 119, 122–24 (2005); Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 LAW &

Congress has also long eschewed the notion of substantive rulemaking, instead opting for a system of full disclosure that allows investors the opportunity to evaluate the merits of a company's actions.¹⁶⁰ The executive compensation disclosure rules, as the name implies, continue the SEC's long legacy of focusing on the disclosure of information as opposed to substantive rulemaking.¹⁶¹ The SEC and federal regulators generally justify the disclosure regime as the most efficient method of ensuring that investors do not make poor decisions as a result of being uninformed.¹⁶² This level of government involvement falls between the extremes of "mere prevention of fraud under criminal law and passing on the merits of an investment, as can be the case under state law."¹⁶³ For nearly the entirety of its history, the SEC has adopted the position first articulated by Louis Brandeis, that "the prospect of disclosure of certain information deter[s] unethical behavior . . . [and that the] disclosure of material facts [can remedy] social and industrial diseases."¹⁶⁴

Most likely, this very same rationale at least partially explains the SEC's hesitancy to promulgate a substantive rule prohibiting the practice of backdating equity option grants.¹⁶⁵ However, the SEC's reliance on its oft-proclaimed disclosure regime has fallen by the wayside in the wake of unprecedented corporate meltdowns and the passage of Sarbanes-Oxley in 2002.¹⁶⁶ Unlike prior efforts at

CONTEMP. PROBS. 113, 113-14 (1999); Peter L. Cholakis, Comment, *Company Disclosure of Earnings Projections: Should Individual Investors Be Allowed Into the "Ball Park"?*, 39 SANTA CLARA L. REV. 819, 824 (1999).

160. HAZEN, *supra* note 14, at 22 ("It is a basic tenet of federal securities regulation that investors' ability to make their own evaluations of available investments obviates any need that some observers may perceive for the more costly and time-consuming governmental merit analysis of the securities being offered.").

161. See HAMILTON, *supra* note 36, at 79 (clarifying that the SEC does not seek to encourage or discourage the use of backdated stock options, so long as companies provide "full and fair disclosure of compensation information to the extent material or required by Commission rule").

162. See Craft, *supra* note 159, at 122-24; Fox, *supra* note 159, at 113-14.

163. BARTOS, *supra* note 14, at 2.

164. In his famous book, *Other People's Money and How the Bankers Use It*, Brandeis declared that "sunlight is said to be the best of disinfectants; electric light the most efficient policeman." LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* 62 (1914). See also BARTOS, *supra* note 14, at 1-2 ("Potential investors are assumed to be capable of making their own investment decisions when they have at their disposal sufficient information concerning the issuer and the issued securities.").

165. Interview with Thomas L. Hazen, Cary C. Boshamer Professor of Law, Univ. of N.C., in Chapel Hill, N.C. (Oct. 10, 2006).

166. Although the preamble to the Sarbanes-Oxley Act states that the purpose of the legislation is to "protect investors by improving the accuracy and reliability of corporate disclosures," the practical effect of the legislation was the creation of substantive

regulating corporate conduct, Sarbanes-Oxley was unprecedented in its breadth,¹⁶⁷ directing the SEC to promulgate an array of substantive regulations¹⁶⁸ designed to “increase the transparency, integrity, and accountability of public companies.”¹⁶⁹ In hindsight, Sarbanes-Oxley marked the onset of a reactionary era in securities regulation, where Congress, along with the SEC, served notice on the investment community that the complacent ethical environment shrouding the 1990s would no longer be tolerated.¹⁷⁰ Although Sarbanes-Oxley certainly contains a wide array of disclosure provisions, “the clear thrust of [the legislation] is to improve corporate governance.”¹⁷¹ Many commentators believe that Sarbanes-Oxley “goes further than any of the earlier securities laws . . . in dealing directly with corporate governance,” perhaps evidencing a new era of substantive securities regulation focusing more on corporate governance practices and less on principle-based disclosure.¹⁷²

To ensure adequate enforcement of its new mandate from Congress, the SEC was also given significant power in administering substantive issues of corporate governance.¹⁷³ In the spirit of Sarbanes-Oxley, contemporary corporate practices, such as options backdating, call for the same aggressive and substantive regulation used to eliminate abusive corporate excesses in the wake of Enron and related scandals. The deceptiveness of backdating equity option grants requires the SEC to prohibit backdating practices altogether,

prohibitions on certain types of corporate behavior. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.). For a discussion of many of these substantive measures, see J. Brent Wilkins, *The Sarbanes-Oxley Act of 2002: The Ripple Effects of Restoring Shareholder Confidence*, 29 S. ILL. U. L.J. 339, 345–46 (2005).

167. See Note, *The Good, The Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 HARV. L. REV. 2123 (2003).

168. Perhaps the most glaring substantive prohibition contained in Sarbanes-Oxley is the blanket prohibition on personal loans to corporate executives. See Sarbanes-Oxley Act of 2002 § 402, 15 U.S.C. § 78m(k) (Supp. II 2002). For a comprehensive discussion of the provisions of Sarbanes-Oxley directly pertaining to the loan practices of corporate boards, see HAZEN, *supra* note 14, at 351.

169. Note, *supra* note 167, at 2123.

170. David H. Kistenbroker et al., *Criminal and Civil Investigations: United States v. Stein and Related Issues*, in STOCK OPTION PRICING PRACTICES: WHAT YOU NEED TO KNOW, *supra* note 55, at 401, 405.

171. HAZEN, *supra* note 14, at 26.

172. See, e.g., *id.* at 26–27 (discussing the specific provisions of Sarbanes-Oxley that deal with substantive matters of corporate governance).

173. *Id.* at 800–01 (noting, however, “that Sarbanes-Oxley could be the beginning of a sea of change by focusing federal law more and more on corporate governance and other areas of corporate law that have traditionally been left to the states”).

as opposed to merely reaffirming existing securities laws by mandating their disclosure.

Perhaps most puzzling is the fact that the SEC already possesses the regulatory authority to create an outright prohibition on backdating options.¹⁷⁴ Congress extended extraordinarily broad regulatory authority to the SEC in § 10(b) of the 1934 Act.¹⁷⁵ This particular section of the 1934 Act is one of the broadest statutes on record, providing a “long-arm provision” with which the SEC is permitted to regulate or prohibit a wide range of potentially destructive conduct.¹⁷⁶ In enacting § 10(b), Congress manifested its intent to protect the investment community from any “manipulative or deceptive device or contrivance” associated with the sale of securities.¹⁷⁷ The only incentive that companies possess for backdating an option award is to disguise an in-the-money option by making it appear as though the grant was issued at-the-money.¹⁷⁸ “At the very least there is intent to deceive as to the grant date of the option.”¹⁷⁹ Certainly, protecting shareholders from deceptive backdating practices constitutes the very species of “manipulative or deceptive” behavior that Congress has directed the SEC to regulate.

Recognizing the deficiencies of the new disclosure rules and the existing federal securities regime, some activist shareholders and public pension funds are not waiting idly for government-sponsored solutions to the backdating epidemic.¹⁸⁰ Hundreds of derivative and

174. See 15 U.S.C. § 78j(b) (2000 & Supp. III 2003).

175. See HAZEN, *supra* note 14, at 326. The extraordinarily broad scope of the 1934 Act serves as a contrast to the 1933 Act which focuses almost exclusively on the sale and purchase of securities. See *id.* The 1934 Act has “a much broader focus both with regard to transactions in securities and also with respect to regulation of the markets and the securities industry.” *Id.*

176. See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 463 (1990). Pursuant to the congressional authority granted by § 10(b), the SEC promulgated rule 10b-5, which is largely coextensive with the original statute passed in the 1934 Act. See 17 C.F.R. § 240.10b-5 (2006).

177. Securities and Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2000) (“It shall be unlawful for any person . . . (b) [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe.”); see also 17 C.F.R. § 240.10b-5 (“It shall be unlawful . . . to employ any device, scheme or artifice to defraud . . . or . . . engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”).

178. Narayanan et al., *supra* note 58 (manuscript at 22).

179. *Id.*

180. The California Public Employees’ Retirement System (CalPERS) and the Minnesota Board of Investment have already opposed the reelection of two directors on the board of UnitedHealth, and the Council of Institutional Investors has sent letters to a

class action lawsuits have already been filed, alleging violations of a wide array of federal and state securities laws.¹⁸¹ Other groups have taken a different approach, expressing their intention to file shareholder proposals that would either mandate enhanced disclosure of equity option awards that go well beyond the requirements set forth in the new SEC disclosure rules or prohibit abusive option timing practices altogether.¹⁸² Shareholders and institutional investors would be well advised to propose stringent internal restrictions or outright prohibitions on backdating option grants, as opposed to accepting the new SEC regulations as a conclusive remedy to abusive option timing practices.

Other related shareholder proposals also have the potential to favorably complement existing federal securities regulations. Proposals that encourage executive compensation committees to adopt fixed grant dates for option packages will almost certainly succeed in alleviating any specter of timing improprieties, as would proposals mandating the immediate disclosure of option awards, as opposed to waiting the two business days permitted under Sarbanes-Oxley.¹⁸³ Slightly less effective, though nevertheless desirable proposals would include those that prohibit directors from granting option awards when executives possess material corporate information that is likely to favorably influence corporate stock prices.¹⁸⁴

The scandal surrounding the backdating of stock options is only “the latest reminder that the boards at many U.S. companies still have much work to do to ensure that stock-options align the interests” of shareholders and management.¹⁸⁵ Continued reminders of abusive option timing practices plague Wall Street with the coming of each new business day, as more lawsuits are filed, more companies disclose option timing irregularities, and more financial results are restated.¹⁸⁶ Although the precise outlook remains unclear, 2007 may very well bring additional restatements, investigations, and

multitude of companies requesting an explanation of any company policies pertaining to the timing of option grants and other executive compensation practices. ALLEN & MISHRA, *supra* note 5, at 5.

181. See Vinson & Elkins LLP, *supra* note 52.

182. See ALLEN & MISHRA, *supra* note 5, at 5.

183. See 15 U.S.C. § 78p(a)(4) (Supp. III 2003) (requiring that changes in beneficial ownership must be filed with the SEC by the end of the second business day after the day of execution of the transaction).

184. See ALLEN & MISHRA, *supra* note 5, at 6.

185. *Id.*

186. Gordon, *supra* note 77.

indictments.¹⁸⁷ And while the SEC's new backdating disclosure requirements represent an admirable attempt at quelling the backdating controversy, it is unlikely that the executive compensation disclosure rules will impose any new requirements for backdated options that were not already in place under existing federal securities laws.

As equity option plans continue to form the centerpiece of executive compensation packages, it is more important than ever that the SEC remain vigilant in combating abusive corporate practices that victimize American investors. The newest executive compensation disclosure rules fail to demonstrate a concerted commitment by the SEC to protect shareholders from illegal option timing practices. Indeed, corporate executives may find themselves in an even more favorable position after the new disclosure rules in terms of their ability to backdate option grants. The SEC's conscious decision to require only the disclosure of backdated option grants, as opposed to providing a blanket prohibition of such practices, serves as a tacit indication that the SEC accepts backdating as a legitimate practice. In the future, the SEC should instead directly address the manipulative timing of option grants by banning deceptive practices that serve no legitimate purpose other than to disguise executive compensation grants.¹⁸⁸

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187. *Id.*

188. *See supra* notes 155–56 and accompanying text. The practice of granting discounted equity option packages provides corporations with the same benefits as those derived from backdated options, simply in a less deceptive format.