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Lara E. Muller

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STOCK OPTION BACKDATING: IS THE GOVERNMENT’S RESPONSE ENOUGH TO ELIMINATE THE PROBLEM OR IS IT STILL A WORK IN PROGRESS?

Lara E. Muller*

I. INTRODUCTION

In 2006, anyone who read the Wall Street Journal was certainly aware that the “scandal du jour” involved the backdating of employee stock-options grants.1 Employee stock options provide employees with a contractual right to buy the company’s stock at the current market price at a time in the future.2 The value of the option “lies in the prospect that the market price of the company’s stock will increase.”3 In an attempt to boost the value of options to employees, and to allow employees to realize an immediate gain, many companies backdate the grant date to a point in time when the fair value of the company’s stock was lower than its current market value.4 In most cases, the practice of backdating stock options is problematic because it results in understated compensation expense and overstated earnings

* Managing Editor, Santa Clara Law Review, Volume 51; J.D. Candidate, Santa Clara University School of Law, May 2011; LLB Bachelor of Laws, University of Reading, England, July 2005. I would like to thank the Santa Clara Law Review Board of Editors and Associates for their contributions to my comment. I would also like to thank Professor Rachel H. Smith for all her advice and enthusiasm during the research and drafting stages. Finally, I want to express my sincere appreciation to my family and friends for their ongoing support.

3. Id.
4. Id.
per share on companies' income statements.\(^5\)

In May 2005, Professor Erik Lie published a study that identified this practice and "unleashed a firestorm of controversy in the investment community."\(^6\) Although the Securities and Exchange Commission ("SEC") had investigated a few isolated instances of backdating, Lie's study was the first indication of a more pervasive backdating phenomenon.\(^7\) Lie's publication did not mention any companies by name, but in March 2006, the Wall Street Journal published an article drawing widespread public attention to the issue and identifying several companies with "highly suspicious granting practices."\(^8\) Subsequently, the SEC launched more than 140 investigations,\(^9\) and it enacted new compensation disclosure rules spawning more interest and comments than any other regulations in the SEC's seventy-two year history.\(^10\)

Currently, backdating is not illegal unless a company fails to disclose the backdated grant as a compensation expense in its financial statements.\(^11\) Such a failure may constitute a violation of securities laws, accounting rules, and tax laws.\(^12\) Nevertheless, companies continue to backdate options without disclosing the activity.\(^13\) Thus, it appears that the current regulations have not, and likely will not, eliminate the problem.\(^14\) In addition to the violations of the aforementioned laws, backdating also harms shareholders in

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7. Id. at 1204.


9. Mark Maremont, Backdating Likely More Widespread, WALL ST. J., Aug. 18, 2009, at C1 (discussing the results of the recent study conducted by Scott Whisenant and Rick Edelson, researchers at the University of Houston's C.T. Bauer College of Business). The SEC investigations included many of the companies named in the Wall Street Journal article. See BICKLEY & SHORTER, supra note 2, at 31.

10. Shipman, supra note 6, at 1196–97.

11. See BICKLEY & SHORTER, supra note 2, at 1.

12. Id.

13. Id. at 32.

14. See id.
several ways. Given the pervasive use of backdating and the attendant harm to shareholders, the issue merits an analysis of the deficiencies in the current regulatory and enforcement schemes. Further, the issue warrants a discussion of various solutions that might put a much needed end to the backdating scandal.

First, this comment will discuss the characteristics of a stock option and the reasons why companies engage in the practice of backdating. Second, this comment will discuss the current state of the law regarding stock option backdating and the governmental response to the issue. Third, this comment will discuss the problems with the existing regulations. Finally, this comment will propose additional regulations that will increase awareness of the backdating problem, will promote self-regulation, and will circumvent SEC resource issues.

II. STOCK OPTIONS AND THE BACKDATING ISSUE

A. What Are Stock Options?

Employee stock options give employees a contractual right to buy a company's common stock at a specified exercise price, and in accordance with certain vesting provisions. The exercise price is usually the fair market value of the company's common stock at the time of the grant, with the underlying incentive that the fair market value of the stock should increase at some point in the future. Vesting provisions allow "a corporation to sell stock to an employee in the future at today's price . . . to encourage continued employment." Thus, stock options are used by companies to

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15. See TIMING OF STOCK OPTIONS, supra note 5, at 1. For example, if the backdating is discovered, the lack of disclosure can lead to costly financial restatements and litigation, which in turn reduces the shareholder value. See id.
16. See infra Part II.A–B.
17. See infra Part II.C–G.
18. See infra Part III–IV.
19. See infra Part V.
20. BICKLEY & SHORTER, supra note 2, at 1.
21. Id.
“compete for the services of scarce employees; . . . [to] discourage existing employees from changing employment; and . . . [to] encourage employees to make extra efforts on behalf of the corporation with the goal of increasing the value of the corporation’s stock.”

In connection with the stock market boom of the 1990s, the grant of stock options as a means of compensating employees increased dramatically. Additionally, various legislative and accounting rule changes affected granting patterns. First, although 1993 legislation capped a public company’s compensation deduction for its top executives at one million dollars, performance based compensation was excluded from this amount. Thus, stock options allowed a company to provide competitive compensation to its executives, while at the same time, avoiding certain tax liabilities. Second, there was no obligation to report stock options as a cost on the company’s financial statements, resulting in stock option grants that had no impact on reported earnings. Third, as marginal tax rates were increased in 1993, it “gave an incentive to individuals to receive forms of remuneration that would be taxed at a lower rate.” More specifically, gains on certain stock options were, and still remain, subject to the lower long term capital gains rates.

23. Id. at 5.
24. BICKLEY & SHORTER, supra note 2, at 6.
25. Id.
26. Id. at 6-7. See also I.R.C. § 162(m) (2002).
27. BICKLEY & SHORTER, supra note 2, at 6-7.
28. Id. at 8. In 2004, however, a new accounting rule was adopted, “which requires public companies to incorporate the estimated value of their option grants as a cost in their financial disclosures.” Id. at 8 n.22; SHARE-BASED PAYMENT, Statement of Fin. Accounting Standards No. 123 (Fin. Accounting Standards Bd., revised 2004). This requirement has resulted in a decrease in option grants. BICKLEY & SHORTER, supra note 2, at 8 n.22. It has been argued that if this law had faced less opposition at the outset and had been adopted in the 1990s, it is possible that the executive compensation problems that have developed would not have been so severe. Id. at 8; see also infra Part II.D (discussing FAS 123(R)).
29. BICKLEY & SHORTER, supra note 2, at 6.
30. Id. at 5. Gains on stock issued pursuant to a stock option are taxed at the long term capital gains rate if the stock is held for one year following the exercise date and two years from the date of grant. Id.
B. What Is Backdating?

Stock options are normally granted with “an exercise price that equals the current price of the stock at the time of grant.”\(^{31}\) Backdating occurs when the company sets “a grant date that precedes the actual date of the corporate action” to give the stock option a lower exercise price and a higher value.\(^{32}\) When the exercise price is lower than the fair market value at the time of grant, an option is said to be “in-the-money.”\(^{33}\) Academic studies show that the practice of backdating has been very widespread in the last two decades.\(^{34}\) One study examining grant activity between 1996 and 2005 estimated that twenty-nine percent of the sample companies had engaged in the backdating of executive stock options during that time span.\(^{35}\)

Many companies view backdating stock options as an acceptable practice, because these companies “desire to keep the price of their common shares low . . . to make stock incentives more attractive to their employees.”\(^{36}\) Without backdating, this is not easy for a public company, with little control over its market value, to achieve.\(^{37}\) Another reason a

\(^{31}\) Kaufman, supra note 1, at 47.

\(^{32}\) Id. The higher value results from manipulating the timing of the option in such a way that it is already in-the-money immediately upon grant, increasing potential gain to the recipient. See id. There are several forms of timing manipulation that can be problematic. BICKLEY & SHORTER, supra note 2, at 28. Sometimes, option grant dates are changed retroactively to fall upon a date when the company’s stock was at its lowest price over a period of time. Id. at 1. Other times, option grants are timed around company announcements. Spring-loading occurs when options are granted prior to positive public announcements and a price boost is anticipated. Id. at 28. Conversely, bullet-dodging occurs when options are granted after a negative public announcement and a price drop is anticipated. Id. Another form of timing manipulation occurs when announcements are timed around scheduled grant dates. Id. A final form of timing manipulation occurs when option exercise dates are changed to increase the holding period and qualify any gain upon sale for capital gains treatment. Id. This comment will only discuss the first of these forms of timing manipulation, as this is the form that has been subject to the most amount of scrutiny since 2005. See id. at 28 n.87.

\(^{33}\) BICKLEY & SHORTER, supra note 2, at 1. When the exercise price is equal to the market price, an option is said to be “at-the-money.” Id. When the exercise price is more than the market price, the option is “out-of-the-money.” Id.

\(^{34}\) See id. at 9.

\(^{35}\) Id.

\(^{36}\) Allan et al., supra note 22, at 24.

\(^{37}\) Jill Andresky Fraser, Private Company Stock, INC. (May 1, 2000), http://www.inc.com/magazine/20000501/18710.html. But this might explain
company may choose to backdate is that because there is a guaranteed gain attached to the option, the company can therefore grant a smaller number of option shares to an employee without reducing the underlying economic incentive. Consequently, this also means that backdating reduces the risk of dilution to existing stockholders because the company can reduce the number of shares that underlie the options.

Stock option backdating has been particularly concentrated in the technology sector, most likely because this area consists of many companies with volatile stock prices. In addition, "[s]tock options started as a method for luring scarce technical talent to take a chance on the future rewards from a risky start-up." In the late 1990s, when the technology boom was near its peak, "talent became even scarcer, prompting companies to look for ways to increase the value of the reward . . . . [and] [b]ackdating options became the solution." Usually, leaders of these technology companies "[were] rule-breakers to start with," sought to "think outside the box," and generally paid little attention to the "details of running a business." Furthermore, in many cases, these companies' financial officers and attorneys were not advising against these practices because they were unaware that failure to disclose the practice was illegal.

Nevertheless, not all backdating is problematic.

why private companies, with more control over their stock price, have stayed out of the spotlight in recent backdating investigations when many public companies have not. How Backdating Stock Option Grants Could Create Future Problems for Private Companies Too, CLIENT ALERT (Ulmer Berne, LLP, Cleveland, Ohio), August 2006, at 1, available at http://www.ulmer.com/SiteCollectionDocuments/ClientAlerts/BackdatingStockOptionsAugust2006.pdf [hereinafter Ulmer Berne].

38. Kaufman, supra note 1, at 46.
39. Id.
40. Shipman, supra note 6, at 1205.
41. Id.
43. Id.
44. Id.
45. Id. This confusion may have been caused by the initial failure of the SEC to address or take a firm position on the legality of backdating. Shipman, supra note 6, at 1215.
46. See generally Patrick Richard, Bryan Barnhart & Krystal LoPilato, Backdating Is Not Always Fraudulent: How to Distinguish Between Lawful and
Backdating "has long been [used as] a common and useful corporate-housekeeping tool" to give retroactive effect to directorial resolutions. This type of backdating is more suitably called "ratification" and is an "appropriate practice," so long as the required procedures are followed and the proper disclosures are made. Since the unearthing of the scandal in 2005, the government's main concern has not been with "the propriety of backdating," but has instead been focused on the directors and officers who used improper retroactive resolutions to commit fraud. The question has not been what was done, but why. Backdating alone is not illegal. But when it is accompanied by fraud, or a purpose that can only be achieved by non-disclosure, such as giving employees compensation that does not have to be reported to the regulators or the Internal Revenue Service ("IRS"), it becomes problematic.

C. The Discovery of the Scandal

In 2005, the practice of undisclosed backdating was discovered, and subsequently generated an investigatory response by various governmental agencies. Yet, it was not the SEC that actually discovered this pattern of granting behavior. It was Professor Erik Lie, publishing an academic study in 2005, who first revealed the pervasive use of unreported backdating. In his research, Lie noticed that many executive grants were conveniently timed to coincide with a stock's low value point. He noted that the "abnormal

Fraudulent Ratification, in ANDREWS SPECIAL REPORT, supra note 1, at 9.

47. Id.
48. Id.; see, e.g., Hibernia Sav. & Loan Soc'y v. Belcher, 4 Cal. 2d 268, 272, 275–76 (1935) (holding that a director who was absent during a board vote may ratify the action at a later time); Kalageorgi v. Kamkin, 750 A.2d 531, 540 (Del. 1999) (permitting a board to use ratification to authorize a grant of stock shares to the directors themselves, effectively backdating the stock grants by almost ten years).
50. Id.
51. Id. at 12.
52. See Erik Lie, On the Timing of CEO Stock Option Awards, 51 MGMT. SCI. 802 (May 2005) (discussing the findings of his study that suggest many executive option grants are retroactively timed).
53. See infra Part II.E–F.
54. See generally Lie, supra note 52. Erik Lie is a Professor of Finance at the University of Iowa. See Stecklow, supra note 8.
55. Lie, supra note 52, at 810.
stock returns [were] negative before unscheduled executive option awards and positive afterwards.\textsuperscript{56} Previously, scholars had hypothesized that these option grants were timed in advance of expected price boosts or positive news releases.\textsuperscript{57} Lie predicted, however, that these awards were "timed ex post facto" because executives' are positioned within a company to have a superior ability to forecast a stock price's exact response to business developments.\textsuperscript{58} Furthermore, Lie noted that the backdating patterns appeared to be absent for grants that were scheduled in advance and, thus, believed that the "manipulation of the information flow played, at best, a minor role" in justifying the patterns.\textsuperscript{59}

Prior to publication, Lie sent a copy of his article to the SEC and "later received an acknowledgement stating it was interesting."\textsuperscript{60} His article did not cite any companies by name, but it did trigger a Wall Street Journal article that used statistical analysis to identify companies with suspicious granting patterns.\textsuperscript{61} Following exposure in the Wall Street Journal article, "the scandal gained wide public attention."\textsuperscript{62}

D. The Problems Associated with Backdating Prior to the Discovery of the Scandal

Before the scandal erupted in 2005, there were several indirect mechanisms in place to protect shareholders against the risks of backdating and to penalize the actors involved in the backdating transaction. These risks included economic consequences of tax, accounting, and legal issues.\textsuperscript{63}

Under the Internal Revenue Code, stock options issued below fair market value are not exempt for purposes of the one million dollar executive compensation deduction cap

\begin{itemize}
  \item \textsuperscript{56} Id. at 802.
  \item \textsuperscript{57} Id. at 810. This is also referred to as spring-loading. See supra note 32 and accompanying text.
  \item \textsuperscript{58} Lie, supra note 52, at 810.
  \item \textsuperscript{59} Randall Heron & Erik Lie, Stock-Option Backdating: Where Are We Now? An Update From the Authors of the Research That Uncovered the Practice, in ANDREWS SPECIAL REPORT, supra note 1, at 3, 4.
  \item \textsuperscript{60} Stecklow, supra note 8.
  \item \textsuperscript{61} Id.
  \item \textsuperscript{62} Id.
  \item \textsuperscript{63} See M. P. Narayanan, Cindy A. Schipani & H. Nejat Seyhun, The Economic Impact of Backdating of Executive Stock Options, 105 MICH. L. REV. 1597, 1600 (June 2007).
\end{itemize}
under section 162.64 Furthermore, if these options are issued below the fair market value, the difference between the exercise price and the fair market value is taxable at the ordinary income rate instead of the preferential long-term capital gains rate.65 Additionally, if the backdated stock options are viewed as "nonqualified deferred compensation,"66 there could be additional personal tax liabilities.67 These liabilities arose when the government adopted section 409A of the Internal Revenue Code as part of the American Jobs Creation Act of 2004, as a response to concerns regarding executive compensation abuses and rising corporate scandals.68 Under section 409A, nonqualified deferred compensation in the form of in-the-money stock options vesting after December 31, 2004 are subject to tax at the time of vesting, instead of at the time of exercise.69 Even though section 409A was not aimed specifically at the problem of backdating, given its position within the scandal's timeline, it could have reduced the practice significantly.70 Moreover, the "provision applies to all companies, not just publicly traded ones, which makes compliance . . . a concern for all businesses."71

In addition to these tax provisions, backdating also violates an accounting principle.72 Under the Financial

64. See supra note 26 and accompanying text; see also I.R.C. § 162(m) (2002).
66. Nonqualified deferred compensation is compensation that is earned, but there is a delay in "the receipt of compensation and taxes on compensation to a future tax year." BICKLEY & SHORTER, supra note 2, at 13. Most stock options are considered "nonqualified deferred compensation" under the tax code as long as they are granted at fair market value. William B. Mateja & Leslie B. Willis, Backdating Stock Options: In the Money and Under Investigation, What the Government is Doing and What You Should Do in Response, in ANDREWS SPECIAL REPORT, supra note 1, at 19, 23.
67. TIMING OF STOCK OPTIONS, supra note 5, at 1. These tax liabilities include "regular tax plus an additional 20 percent income tax to the option recipient on the date of option vesting," instead of the date of exercise or sale, plus interest. Kaufman, supra note 1, at 47.
68. I.R.C. § 409A (West Supp. 2005); see also BICKLEY & SHORTER, supra note 2, at 13.
69. Narayanan et al., supra note 63, at 1620–22 (explaining the implications of section 409A as an exception to the regular tax rules relating to deferred compensation).
70. BICKLEY & SHORTER, supra note 2, at 12.
71. Mateja & Willis, supra note 66, at 23.
72. See Narayanan et al., supra note 63, at 1623–24.
Accounting Standard 123(R), employee stock options must be expensed at the fair market value as of the date of grant. Thus, backdating may result in “understated compensation expense and overstated earnings per share on the income statement . . . [and] could potentially require restatement.”

Backdating triggers several additional legal issues. When options are backdated, “shareholders may be misled into believing that management’s interests are firmly aligned with theirs . . . when in fact executives can receive additional compensation without stock prices rising,” resulting in extra compensation expense. Without full disclosure of these granting practices to the shareholders, it is “misleading to certify the financial statements as compliant” with accepted standards, and it is certainly inconsistent with the purposes of federal securities laws. Backdating without proper disclosure runs contrary to executives’ “fiduciary duties of care and loyalty” to the corporation and its shareholders. Additionally, securities laws provide that it is unlawful for a

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73. SHARE-BASED PAYMENT, Statement of Fin. Accounting Standards No. 123 (Fin. Accounting Standards Bd., revised 2004).
74. See Narayanan et al., supra note 63, at 1623. This rule became effective in 2005 replacing the previous requirement that companies merely report the fair market value of option grants in the footnotes to the financial statements. Id.
75. TIMING OF STOCK OPTIONS, supra note 5, at 1. When a company grants stock options with a discounted exercise price, the difference between the exercise price and the fair market value is treated as “camouflaged pay.” See Narayanan et al., supra note 63, at 1600. Consequently, the companies’ compensation expense is understated when the backdated options are undisclosed because the company has failed to record that amount as a compensation expense on its financial statements. See id. at 1606. Similarly, the companies’ earnings are inflated because companies are required to “subtract the expense of the estimated value of their option grants from their earnings.” BICKLEY & SHORTER, supra note 2, at 13. If the company’s compensation expense and earnings are inaccurate and are not restated, shareholders making an investment decision might be misled with respect to the company’s financial condition. See Mateja & Willis, supra note 66, at 21.
76. See Narayanan et al., supra note 63, at 1606–07.
77. Id. at 1606.
78. Id.
79. Id. at 1606 n.39–40 (noting that the purpose of these laws was to promote full and fair disclosure and to better protect investors).
80. Id. at 1615. The duty of care is only discharged if the backdating is disclosed and approved by an independent committee of the board. Id. at 1616. The duty of loyalty requires that fiduciaries not “personally profit at the expense of the company.” Id. at 1617 (citing Guth v. Loft, 5 A.2d 503, 520 (Del. 1939)).
person engaging in the sale of securities to use manipulative or deceptive devices.\textsuperscript{81} This makes it unlawful for any person to “employ any device, scheme, or artifice to defraud” or “make any untrue statement of a material fact.”\textsuperscript{82} Backdating of options “appear[s] by [its] nature to fall within the current standards for material misrepresentation.”\textsuperscript{83}

In late July 2002, the Sarbanes-Oxley Act went into effect and reduced the filing deadlines for reporting option grants to regulators on Form 4 from forty-five days to two days.\textsuperscript{84} Thus, any option that is backdated by more than two days also violates Sarbanes-Oxley.\textsuperscript{85} This Act was passed as a response to major corporate and accounting scandals, such as Enron, and was designed to boost the public’s confidence in the market by enhancing the corporate accounting controls.\textsuperscript{86} A subsequent study by Erik Lie showed that the newly implemented, more stringent filing deadline imposed by this legislation substantially curtailed backdating, yet it did not eliminate it completely.\textsuperscript{87} Lie demonstrated that “when

\begin{itemize}
\item \textsuperscript{83} Narayanan et al., supra note 63, at 1607–09 (noting that to determine materiality, the courts consider factors such as whether disclosure would affect the stock price or if there is a likelihood that a reasonable investor would consider the fact important in making an investment decision).
\item \textsuperscript{85} See BICKLEY & SHORTER, supra note 2, at 14.
\item \textsuperscript{86} John Paul Lucci, Enron—The Bankruptcy Heard Around the World and the International Ricochet of Sarbanes-Oxley, 67 ALB. L. REV. 211, 216 (2003). In 2000, Enron was a very successful “high-tech global enterprise,” and with revenues exceeding $100 billion, it was the “seventh largest company by market capitalization of the Fortune 500.” Marlene A. O’Connor, The Enron Board: The Perils of Groupthink, 71 U. CIN. L. REV. 1233, 1233 (2003). In October 2001, however, Enron astounded “Wall Street by revealing a $544 million charge to earnings and a $1.2 billion reduction of shareholder equity.” Id. This was a result of related party transactions that allowed Enron to inflate its earnings for five years and keep its liabilities off the balance sheets. Id. at 1234. Shortly thereafter, the market lost confidence in the company and Enron was forced to file bankruptcy. Id. Shareholders lost billions of dollars and “thousands of employees lost their jobs and retirement savings.” Id. This “debacle [was] one of the United States’ most disastrous business failures.” Id. at 1233.
\item \textsuperscript{87} BICKLEY & SHORTER, supra note 2, at 32; see also Randall A. Heron & Erik Lie, Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?, 83 J. FIN. ECON. 271, 280 (February 2007) [hereinafter Heron & Lie 2007] (discussing the effect that Sarbanes-Oxley had on backdating).
\end{itemize}
companies reported options the same day they were granted, there was no pattern of share prices quickly rising." Nevertheless, "the pattern continued when companies delayed reporting option grants." Lie concluded that to eradicate backdating, "the requirements need[ed] to be tightened further" and needed to be strictly enforced.

E. Responding to the Discovery of the Backdating Scandal

In response to the discovery of the scandal, the government adopted various new rules and regulations, on top of the existing mechanisms, in an attempt to swiftly control the problem. In July 2006, the SEC adopted changes to the executive compensation public company reporting requirements. The new rules require companies to disclose the fair value of the stock on the date of grant, the closing market price if it is higher than the fair value, and the date the board or committee met to grant the option, if it is different from the grant date. In addition, the new rules require disclosure of the "methodology used to determine the exercise price if . . . [it] is not the closing price per share on the grant date." The company must also disclose information about its granting policies, including why it picks "certain dates for awarding stock options and how it determines the exercise price."

In July 2006, the Public Company Accounting Oversight Board ("PCAOB") issued an audit practice alert in response to the backdating problem. The alert recommended that

88. See Stecklow, supra note 8.
89. Id.
90. BICKLEY & SHORTER, supra note 2, at 32.
91. Mateja & Willis, supra note 66, at 23.
92. Id.
93. Id.
94. Id.
95. Id. Companies must now be prepared to answer questions such as: Does [the] company have a program to time option grants in coordination with the release of material, nonpublic information? How does the company's plan for granting options to executives fit in with its plan for granting options to employees? What role did the compensation committee have in making the grant? What role did the executive officers have in the company's timing for granting options?
96. Id. The Public Company Accounting Oversight Board was created by the Sarbanes-Oxley Act of 2002 and is a "private corporation under the SEC's jurisdiction." Id.
auditors and their clients become more diligent in their disclosure of backdated options. As a result of the audit practice report, companies are almost forced to self-regulate and self-investigate to avoid the issuance of an unfavorable auditors' report.

In addition to these preventive steps, the SEC and Department of Justice ("DOJ") launched investigations into the option granting procedures of various public companies, such as Brocade Communications Systems, Inc., Converse Technology, Inc., and Apple, Inc. In July 2006, the IRS also announced that it intended to investigate tax code violations by companies that were already under scrutiny. Notably, backdating is not problematic or illegal unless the corporation fails to comply with securities laws, tax laws, and public company disclosure requirements or accounting procedures. Therefore, the investigations have focused on these secondary issues. Similarly, the regulatory responses discussed above were geared towards enhanced disclosure and were not aimed directly at proscribing backdating.

In its 2006 investigations, the SEC looked for overstatements of earnings and understatements of expenses that might mislead investors with regard to the health of the company. If misstatements were present, then a restatement was required. Restatements of financials can be time consuming, expensive, and can sometimes lead to delinquency in subsequent reporting obligations. Misstatements can also lead to charges of fraud or insider

97. Mateja & Willis, supra note 66, at 24.
98. Id.
100. See Mark J. Rochon & Andrew T. Wise, How to Prepare for Stock-Option Backdating Investigations, in ANDREWS SPECIAL REPORT, supra note 1, at 29.
101. See Kaufman, supra note 1, at 47-48. In fact, several S.E.C. commissioners have opined that properly disclosed option grants are legal even if backdated. Id. at 48.
102. See, e.g., S.E.C. v. Reyes, 491 F. Supp. 2d 906, 907 (N.D. Cal. 2007) (alleging fraud and misstatements in connection with the sale of securities, failures in internal controls, falsification of books and records, fraudulent entries into the company's financial records, and false and misleading statements to outside auditors).
103. See supra notes 91-102 and accompanying text; infra Part II.F.
104. See Mateja & Willis, supra note 66, at 21.
105. See id.
106. Id.
trading, and false certification with respect to the accuracy of the financials or disclosures in SEC filings. The DOJ also investigated related criminal activities and subsequently filed indictments alleging forgery of corporate records to cover up the backdating, conspiracy, mail and wire fraud, and willful violation of the provisions of the Securities Exchange Act of 1934. The IRS looked for activity that should have triggered or accelerated tax liability, such as incorrect exemption of in-the-money grants from the one million dollar compensation cap or nonqualified deferred compensation granted below fair market value. Federal authorities in Northern California also formed a Bay Area Federal Task Force to investigate the issues on a local level because the region is home to "America's leading high-tech

109. It is unclear when backdating will give rise to criminal penalties as well as, or instead of, civil penalties. See John K. Villa, In-house Counsel and Backdating: What Will They Criminalize Next?, ACC DOCKET, January/February 2008, at 74, 80–81, available at http://www.wc.com/assets/attachments/in-house_counsel_and_backdating.pdf. It probably depends on "the strength of the evidence supporting the government's allegations of knowledge of wrongdoing or scienter." Id. at 81. This is because "[i]t is one thing to allege that the general counsel knew or should have known (or was reckless in not knowing), and another to prove knowledge beyond a reasonable doubt." Id. However, it is possible that the "cases where the practice was open and notorious . . . are more likely to reflect lack of scienter because of ignorance of the rules than those where elaborate cover-ups were developed." Id.
110. See Brocade—Indictment, in ANDREWS SPECIAL REPORT, supra note 1, at § A (charging the Chief Executive Officer and Vice President of Human Resources with forgery of minutes to make it look like the compensation committee had met on the backdated grant date and backdating of employment agreements so that employees could receive grants on an earlier date).
111. Id.
112. Id.
113. Richard E. Wood & Michael J. Missal, The SEC's New Executive Compensation Disclosure Rules: Liability Concerns For Officers and Directors, in ANDREWS SPECIAL REPORT, supra note 1, at 37, 43.
114. See Mateja & Willis, supra note 66, at 22–23.
firms and other publicly traded internet businesses."\(^\text{115}\)

In addition to the government actions, private litigants, such as shareholders and employees, have brought class action and derivative suits.\(^\text{116}\) The suits attempted to recover costs caused by earning hits, reduced executive performance because of the diminished incentives, delisting when the company becomes delinquent on its reporting obligations, additional tax liabilities, and legal fees.\(^\text{117}\) The prospect of multiple lawsuits can seriously threaten the longevity of a company.\(^\text{118}\) More generally, these investigations, and the process of restating a companies' financials, can give rise to a finding of a material weakness in a company's internal controls. This display of weakness can lead to a further drop in the company's stock value, defeating the entire purpose of backdating.\(^\text{119}\)

F. A Few Examples of the Securities and Exchange Commission Investigations

After discovering the scandal, the SEC launched investigations into more than 140 companies.\(^\text{120}\) One of the earliest backdating cases materialized from the investigation into Brocade Communications Systems, Inc.\(^\text{121}\) The SEC and DOJ filed criminal and civil charges against the executives at Brocade in July 2006.\(^\text{122}\)

The civil complaint alleged "fraud and misstatements in connection with the sale of securities[,] . . . failures of internal controls and the falsification of books and records."\(^\text{123}\) These allegations were supported by factual descriptions of how records had been altered by executives to make options look like they were granted at an earlier date.\(^\text{124}\) Furthermore, the SEC and DOJ alleged that the executives had made

\(^{115}\) Bay Area Federal Task Force Targets Options Backdating, in ANDREWS SPECIAL REPORT, supra note 1, at 55.

\(^{116}\) BICKLEY & SHORTER, supra note 2, at 9–12 (describing the costs to shareholders and employees that result from backdating).

\(^{117}\) Id.

\(^{118}\) See Mateja & Willis, supra note 66, at 22.

\(^{119}\) Narayanan et al., supra note 63, at 1623–24.

\(^{120}\) See Maremont, supra note 9.

\(^{121}\) BICKLEY & SHORTER, supra note 2, at 2.

\(^{122}\) Rochon & Wise, supra note 100, at 29.

\(^{123}\) Id.

\(^{124}\) Id.
“fraudulent entries into the company’s financial records” and that “false and misleading statements [were made] to outside auditors in order to conceal these acts.” The parties eventually settled this action without admitting or denying any of the allegations.

The criminal complaint alleged similar acts but also “charged that the defendants committed securities fraud by using the mail and the national securities exchanges to promote a scheme [and conspiracy] that violated provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.” Brocade’s Chief Executive Officer, Gregory Reyes, and Vice-President of Human Resources, Stephanie Jensen, were both sentenced to imprisonment. On appeal, Reyes’s conviction was reversed as a result of prosecutorial misconduct; however, he was found guilty for a second time at the retrial and was subsequently sentenced to eighteen months in prison. Jensen’s sentence was vacated because it improperly included an obstruction of justice enhancement; nevertheless, she still faced two months in prison after resentencing.

In addition to the proceedings initiated by the SEC and DOJ, Brocade’s shareholders brought a derivative suit on behalf of the company against Reyes for breach of his fiduciary duties. In August 2007, the SEC also brought another civil action against Brocade’s former Chief Financial Officer, Michael Byrd, “alleging that he [had] disregarded

125. Id.
128. See U.S. v. Reyes, 577 F.3d 1069, 1073–75 (9th Cir. 2009).
131. See Karen Gullo, Ex-Brocade Chief to Pay $12.5 Million to Settle Backdating Case, BLOOMBERG (Oct. 10, 2009), http://www.bloomberg.com/apps/news?pid=20601087&sid=a.FGXFeEx8hg. This action was recently settled for $12.5 million. Id.
indications that other senior corporate executives were improperly backdating" and that he "failed to ensure that the company properly accounted for the option expenses and disclosed them to investors."\textsuperscript{132}

The Brocade investigation and proceedings exemplify the heavy factual nature of all option backdating investigations, and the potential for civil as well as criminal penalties.\textsuperscript{133} Furthermore, it shows that the SEC will pursue corporate gatekeepers who observe the activity, such as Byrd, as well as those who actually commit the fraud.\textsuperscript{134}

The case against Apple, Inc. provides a good illustration of the settlement procedures that can operate in backdating cases. In April 2007, the SEC charged Apple's former General Counsel, Nancy Heinen, and the Chief Financial Officer, Fred Anderson, with backdating executive grants and altering the company records to conceal the fraud.\textsuperscript{135} Both Heinen and Anderson were alleged to have personally received millions of dollars in unreported compensation.\textsuperscript{136} As a result, both were charged with numerous violations of the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934, but no criminal charges were filed.\textsuperscript{137}

Heinen and Anderson both settled with the SEC, received civil penalties, and had to pay all taxes, penalties, and interest on the unreported compensation they received.\textsuperscript{138} In addition, Heinen was enjoined from any future violations and was barred from serving as an officer or director of any public company for five years.\textsuperscript{139} Anderson also agreed to a

\textsuperscript{133} See Rochon & Wise, supra note 100, at 29–30.
\textsuperscript{134} See \textit{Press Release, supra note 132}.
\textsuperscript{136} Litigation Release No. 20086, \textit{supra} note 135.
\textsuperscript{137} See id.; Litigation Release No. 20683, \textit{supra} note 135.
\textsuperscript{138} See \textit{Litigation Release No. 20086, supra note 135; Litigation Release No. 20683, supra note 135}.
\textsuperscript{139} Litigation Release No. 20683, \textit{supra} note 135.
permanent injunction from further violations of the Securities Act and Securities Exchange Act. Unsurprisingly, shortly after Apple issued a press release “stating that its management had discovered irregularities regarding the issuance of certain stock option grants,” the company’s shareholders brought a derivative action. A settlement agreement was subsequently approved, and it was deemed fair and reasonable in light of the requirement that Apple “adopt multiple corporate governance reforms.” Notably, no actions were brought against the Chief Executive Officer, Steve Jobs.

The Brocade and Apple investigations are examples of the SEC’s attempt to quell backdating. At the time, however, critics questioned the SEC’s “ability to both adequately and comprehensively undertake the probes,” given the decline in the SEC’s enforcement resources.

G. Backdating Activity Still Persists Today

In the wake of the scandal, backdating was at the core of most SEC investigations. More recently, however, the SEC has turned its focus elsewhere, allowing unreported backdating to continue unhindered. The SEC believed that its message had been received by companies and executives and, therefore, turned its attention to other matters. Contrary to the SEC’s opinion, a study released in 2009 claimed that most “companies that improperly backdated stock options never were caught by regulators or [did not] confess[] to the practice” through proper disclosure or restatement. The study implied that backdating was prevalent in many companies that were not subject to

142. Id. at *2.
144. BICKLEY & SHORTER, supra note 2, at 2–3.
145. Id. at 21.
146. See Maremont, supra note 9.
147. Id.
148. Id.
149. See id.
investigations, including Omnicom Group, Inc. (an advertising company), The Dress Barn, Inc., J.B. Hunt Transport Services, Inc., and United Rentals, Inc.  

This study not only suggested that the practice might have been more widespread than initially believed, but also undermined the theory that the scandal was primarily limited to the technology sector.  

III. THE PROBLEM WITH THE GOVERNMENT'S RESPONSE TO THE SCANDAL  

Despite passing new regulations, and despite the governmental initiation of investigations in response to the scandal, backdating has not been eliminated. Even though 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." Rather than instituting a blanket prohibition of such practices, the new rules merely reinforce existing laws that already mandated the disclosure of backdated options. Consequently, "the SEC appears to have at least tacitly accepted the legitimacy" of backdating. In addition, the SEC lacks sufficient resources to enforce the new regulations and fully investigate every case of suspected backdating.  

The current regulations do not act as a sufficient deterrent to eradicate the problem, and while backdating may benefit the recipients of the grants, the costs are being carried by the stockholders. The backdating activity that continues undeterred by current regulatory and investigatory mechanisms is harmful to these stockholders. An undisclosed backdated option results in understated compensation expense and overstated earnings per share on the income statement. In turn, this leads to reduced shareholder value.

150. Id.
151. Id.
152. See supra Part II.D–E.
153. Shipman, supra note 6, at 1223.
154. Id. at 1197–98.
155. Id.
156. See BICKLEY & SHORTER, supra note 2, at 20–21.
157. Id. at 9.
158. TIMING OF STOCK OPTIONS, supra note 5, at 1.
and an increased risk of costly restatements or litigation.  

Therefore, the current regulations and enforcement strategies “fail to demonstrate a concerted commitment . . . to protect shareholders” from undisclosed backdating. Academics have suggested that the solution is to require heightened regulation and an enhanced enforcement effort on the part of the SEC. On the other hand, public fear of increased regulation and a lack of available SEC resources for enforcement measures suggest that the solution is not so straightforward.

IV. ANALYZING THE BACKDATING PROBLEM

The problem with unreported stock option backdating is multi-faceted. First, many public companies have escaped notice under current rules that do not sufficiently deter the undisclosed backdating of stock options. Second, there are insufficient government resources available to enforce the current regulations or to investigate every public company that has potentially backdated. Third, there are very few disclosure mechanisms in place for private companies that could trigger investigations or stockholder actions. Fourth, the corporate gatekeepers, such as lawyers and accountants, are immune from liability. And finally, any new regulation will probably be opposed by the pro-laissez-faire members of the public.

159. Id.
160. Shipman, supra note 6, at 1223.
161. See, e.g., Heron & Lie 2007, supra note 87, at 294.
162. See generally infra Part IV.
163. See id.
164. See Maremont, supra note 9.
165. See BICKLEY & SHORTER, supra note 2, at 20–21.
166. See infra Part IV.B.
A. The Public Sector Regulation Is Deficient

Despite the rules and regulations that are in place, and the investigations that were initiated, many public companies still escaped notice; there may be many more companies that still have not, and may never be, subject to investigation.  Furthermore, a 2009 study indicated that the problem is now much more geographically expansive, and that the activity is not just popular within technology concentrated locations, such as Silicon Valley.  In addition, the government’s focus on the technology sector does not seem to have deterred companies in other sectors.

In 2002, Sarbanes-Oxley substantially curtailed the activity of undisclosed backdating by amending the deadline for executives to report grants to the SEC on a Form 4 filing. This curtailment gave “some SEC officials a sense that the abuse [was] largely a thing of the past.” The reform removed, or at least reduced, the opportunity for public companies to “review their earlier stock price performance, identify the low point, and retroactively designate that date as the stock option grant date.” It appears, however, that many companies failed to comply with this deadline. Studies conducted in 2005 showed that roughly thirteen percent of the insider option grant award filings were late. One explanation for this high number of late filings may be that “enforcement against late filers” has traditionally been considered a “low priority area” so there is a minimal compliance incentive. Another explanation is that “continued and widespread backdating,” albeit reduced, still exists. Under Sarbanes-Oxley, if a company files a late Form 4, it must disclose the late filing in a proxy statement.
and on its annual report. Even with these penalties in place, however, late filings have not been eliminated. Thus, if the filings are late because late filings provide companies with greater opportunities to backdate stock options, then Sarbanes-Oxley does not appear to have deterred this behavior.

In 2006, there were an estimated two thousand companies suspected of some sort of manipulation practices. But only a “modest portion of [those] companies” are likely to ever be investigated by the SEC, because of the enormous resources required to uncover more than circumstantial evidence of the backdating. The SEC has acknowledged that due to limited resources, pursuing more companies suspected of undisclosed backdating would be at the expense of enforcement in other areas. These economic restraints, coupled with the lack of enforcement of filing deadlines, provide “greater opportunities for backdating,” lower the deterrent effect, and increase the chance that firms may intentionally backdate.

In addition, the new executive compensation disclosure requirements do not add anything novel to the existing reporting obligations that existed previously; the old rules are merely restated. Instead, the SEC failed to take a position on the practice, and as a consequence, it “appears to have given its tacit acceptance” of backdating. This omission may be a result of the lack of a consensus within the SEC regarding the legality of the practice. But even though this lack of consensus may mean that the current regulations and investigations have not added anything to previous

179. BICKLEY & SHORTER, supra note 2, at 22.
180. See id.
181. Heron & Lie, supra note 59, at 5.
182. Id.
183. BICKLEY & SHORTER, supra note 2, at 20–21.
184. Id. at 24.
185. Shipman, supra note 6, at 1211.
186. Id. at 1215.
187. Id.
regulations, there are positive consequences that may arise out of the increased awareness regarding backdating. In this regard, Professor Erik Lie stated that the media focus alone may be enough to substantially curtail backdating because executives are beginning to recognize that they will not get away with it anymore.

B. The Private Sector Regulation Is Deficient

In the private sector, not only is it harder to determine the actual fair market value of the stock prior to a grant, but it is also harder for the government to enforce the disclosure of a backdated grant because private companies have fewer reporting obligations. Stock pricing in a private company is complicated and is usually a costly endeavor. A private company must either hire an independent appraiser, who will value the stock based on performance and prospects, or the company must negotiate a deal and see how much people are willing to pay for the stock. By contrast, the stock price of a public company is driven by the market and can be ascertained within seconds on the internet or in a newspaper.

Regardless of how a private company chooses to value its stock, it is still subject to the generally accepted accounting principles governing the disclosure of expenses related to compensation. The directors and officers of private companies must also ensure that their actions do not breach their fiduciary duties and trigger a shareholder action.

188. Id. at 1217 (stating that the new disclosure rules 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”).
190. See infra text accompanying notes 191–205.
191. Fraser, supra note 37.
192. Id. This means that the value over time can be compared from year to year. Id. Without this independent valuation, the stock price tends to reflect the purpose for which the valuation was conducted. Id. For example, if the “owner is selling part or all of a company . . . obtaining the highest price is desirable.” Id. If the owner will be subject to tax liability, the lowest price is desirable. Id.
193. Id.
194. See Ulmer Berne, supra note 37, at 2.
195. See Narayanan et al., supra note 63, at 1615–16.
Furthermore, private companies are bound by the provisions of the tax code, including the provisions of the Internal Revenue Code section 409A, which requires stock to be granted at fair value.\textsuperscript{196} Therefore, despite the difficulties in determining the fair market value of a private company's stock, these companies still run the risk of penalties if stock options are backdated and thus granted below fair value.\textsuperscript{197} Although section 409A provides a huge disincentive to backdating, it does not prevent it completely.\textsuperscript{198}

A specific issue for private sector regulation is that there are fewer means available for discovering backdating activity.\textsuperscript{199} The SEC has limited resources to investigate the backdating issue and, as it has already been noted, the initial inquiry into public companies was spawned by Erik Lie's study.\textsuperscript{200} Lie's studies were based on information obtained from public disclosures made in documents that public companies are required to make readily available.\textsuperscript{201} Thus far, the government's regulatory responses and guidelines have only affected public companies.\textsuperscript{202} Because private companies are not required to make similar public disclosures in compliance with federal securities law and regulations,\textsuperscript{203} and since the SEC does not have the resources to investigate further,\textsuperscript{204} this might explain why private companies have remained out of the spotlight.\textsuperscript{205}

\textsuperscript{196} See Ulmer Berne, \textit{supra} note 37, at 2.
\textsuperscript{197} See \textit{id.}; see also Fraser, \textit{supra} note 37.
\textsuperscript{198} BICKLEY \& SHORTER, \textit{supra} note 2, at 13 (highlighting that the consequence of backdating or issuing options below fair value is a reduction in the tax advantage normally applicable to options granted at fair value).
\textsuperscript{199} See Ulmer Berne, \textit{supra} note 37, at 1 (noting that private companies have been almost immune until now).
\textsuperscript{200} BICKLEY \& SHORTER, \textit{supra} note 2, at 23.
\textsuperscript{201} See \textit{generally} Lie, \textit{supra} note 52.
\textsuperscript{202} See \textit{supra} Part II.E (discussing the public company compensation disclosure requirements enacted in 2006 and the recommendations made by the Public Company Accounting Oversight Board).
\textsuperscript{204} See BICKLEY \& SHORTER, \textit{supra} note 2, at 20–23.
\textsuperscript{205} See Ulmer Berne, \textit{supra} note 37, at 1.
C. The Corporate Gatekeepers Should Not be Immune from Liability to Shareholders

Currently, the law provides immunity to professionals, such as lawyers and accountants, from certain shareholder actions. Under section 10(b) of the Securities Exchange Act, it is fraudulent for any person to "make any untrue statement of a material fact . . . in connection with the purchase or sale of any security." 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—is highly likely to be considered a material fact that should be publicly disclosed under section 10(b). Nevertheless, professionals are insulated from civil liability where they have assisted a client who has committed such a fraud because the implied private right of action for securities fraud under section 10(b) does not extend to aiders and abettors. This is true even if the professional drafts or prepares documents or disclosure statements that contain false statements on behalf of a client. These false statements are attributable to the client, not the professional, and the professional's actions amount to nothing more than aiding or abetting.

This civil immunity promotes passivity on the part of lawyers and accountants, and also creates a major gap in enforcement because these individuals are the people that the investing public relies on to review the merits of the statements and transactions. In the past, when liability has been imposed directly on professionals, it has promoted diligence on their part and has reduced the harm sought to be

208. Shipman, supra note 6, at 1212.
209. Kim, supra note 206, at 426–27, 428 n.82. This principle was even applied in the Enron case where lawyers helped the company "to hide billions of dollars of losses from investors and thus artificially inflated its earnings" and stock price. Brent J. Horton, How Corporate Lawyers Escape Sarbanes-Oxley: Disparate Treatment in the Legislative Process, 60 S.C. L. REV. 149, 150 (2008).
210. See Sachdev, supra note 167. Nevertheless, the accounting profession still faces primary liability for the certification of a client's financial statements and, therefore, is slightly less insulated than the legal profession. Kim, supra note 206, at 426–27.
211. See Sachdev, supra note 167.
eliminated.212 There is speculation that accounting firms may have played roles in the backdating, but so far they have not been "implicated for their roles."213 Therefore, the lack of regulation or the availability of a cause of action in this area may be perpetuating the problem.214

For example, Brocade's CEO claimed that the company's outside counsel, Larry Sonsini, was aware of the backdated and undisclosed option grants, and that he approved the activity.215 Yet, Sonsini was not penalized for failing to recommend disclosure or to alert authorities.216 Furthermore, the lawyers working under Sonsini did not notice, or did not report, the sloppy granting techniques utilized at Brocade.217 This level of passivity on the part of outside counsel might be due to the current immunity from liability.218

D. Costs of Regulation Do Not Outweigh Benefits

While it is nearly "universally agreed that backdating is no longer the kind of problem that it was several years ago," it has not been eliminated and further regulation may be required.219 The main problem with tightening regulations is that it imposes a huge burden on small businesses and venture capital because it results in heightened overhead costs.220 These costs are not just costs of business that have to be passed along, but they also deprive smaller companies of the chance to become more competitive in the global market.221 More specifically, additional regulations may have

214. See id.
216. See id.
217. See id.
218. See Sachdev, supra note 167.
219. BICKLEY & SHORTER, supra note 2, at 24.
221. See id.
a negative impact on the technology sector, because they may
deter successful companies that do not want to change their
compensation models from entering the public sector.\footnote{222}

Moreover, there is an argument that backdating was
previously a gray area, but now that everyone is aware of the
problem as a result of the developments since 2005, it will
disappear naturally without need for heightened
regulation.\footnote{223} Even though most lawyers and accountants
were previously unaware of the implications of backdating,
and did not condemn it or proactively recommend disclosure
by clients, most would likely take a pro-disclosure stance
today.\footnote{224} Any board member or in-house counsel who has
gone through one backdating investigation will not want to go
through the ordeal again.\footnote{225} Thus, even without regulation,
the same result could be achieved “if innovators continue to
innovate, but everyone gains a stronger sense of the value of
governance and boards.”\footnote{226}

A study released in 2009, however, concluded that the
new compensation disclosure requirements and SEC
backdating investigations are not proving to be a deterrent
and have not led to a change in corporate behavior or
enhanced disclosures.\footnote{227} The study suggested that nearly
two-thirds of the companies suspected of backdating were not
investigated and the backdating behavior still remains
undisclosed.\footnote{228} Investors have witnessed successful results
from technology leaders who “behave outside the box,”\footnote{229} and
despite the release of this new study in 2009, investors have
not responded negatively.\footnote{230} Perhaps this lack of response

\footnote{222. See Mader, supra note 42.}
\footnote{223. Peter Burrows, Greg Reyes Exonerated On Option Backdating. Why
http://www.businessweek.com/the_thread/techbeat/archives/2009/08/greg_reyes
_exon.html.}
\footnote{224. See id.}
\footnote{225. See Mader, supra note 42.}
\footnote{226. See id.}
\footnote{227. See generally Maremont, supra note 9.}
\footnote{228. Id.}
\footnote{229. See Mader, supra note 42.}
\footnote{230. Megan Barnett, Investors Respond to Backdating 2.0 with
Resounding “Who Cares?”, MINYANVILLE (Aug. 18, 2009),
http://www.minyanville.com/articles/options-backdating/index/a/24116 (noting
that the publication of these studies showing that companies like Dress Barn
are still allegedly backdating did not affect their performance on the stock
market. Instead, Barnett observes that after the announcement, Dress Barn's}
reflects a new shareholder outlook: "if [companies] are smart enough to reward [their] best people and not get caught, [they] must be doing something right." Alternatively, the SEC and shareholders may simply have more pressing concerns to respond to in light of the current economic situation. Indeed, even after the initial round of backdating discoveries, most investors indicated that they were far more concerned with a company's financial performance than with allegations of stock option backdating.

Nevertheless, courts still believe that failure to disclose backdating is a material omission, and that investors should be informed of the additional compensation expense. Furthermore, despite the free marketers' opposition to government intervention, the new regulations introduced in the past few years might actually produce better results than a laissez faire approach. The current laws provide for enhanced disclosure that allows directors and shareholders to make fully informed compensation decisions, but the laws do not intervene to the extent of regulating the level or method of compensation that a company may provide to its employees. Achieving this balance is important because opponents of regulation argue that Americans are strongly opposed to it, but at the same time, the proponents believe that without regulation, Americans will allow themselves to be swindled. As it stands, "it will be up to shareholders, directors, investors and the market to decide how they will use this improved disclosure," but improved levels of
disclosure will almost certainly benefit the economy because investors will have better tools to monitor their investments.\textsuperscript{238} It seems only fair that public shareholders, the owners of the corporation, "have a window into the compensation decisions made by the boards... that represent their interests."\textsuperscript{239}

V. THE GOVERNMENT SHOULD TAKE NOVEL MEASURES

More government intervention and enforcement is needed because the current mechanisms have not eliminated the problems associated with backdating. As mentioned above, the post-scandal-discovery government amendments did not add anything new to the pre-discovery regulations. And although awareness of the problem was increased, it did not disappear. To solve the problem, a new regulatory approach is required that will deter non-compliance in a manner that is not so intrusive that the public will oppose it. The regulations must take the ease of implementation and cost of government enforcement into consideration. Even if the new regulations do nothing more than increase public awareness of the problems associated with undisclosed backdating, they will be effective because they will force the actors to be more critical of practices and to self-regulate.\textsuperscript{240}

A. The Securities and Exchange Commission Should Require Fixed Grant Dates For Public Companies

One way for public companies to avoid the temptation of backdating, or suspicion thereof, is to pre-determine fixed and regular grant dates each year. This would give executives fewer opportunities to manipulate these dates.\textsuperscript{241} Furthermore, this would draw attention to any grants made on different dates and could limit the scope of investigations. Fixed grant dates will not necessarily prevent the grant dates from being backdated to a previous set grant date that fell at a time when the fair value was lower, but this could severely

\textsuperscript{238} See Cox, supra note 236.
\textsuperscript{240} See Heron & Lie, supra note 59, at 7.
\textsuperscript{241} Also, Erik Lie's study showed that the backdating pattern was largely absent for grants that appeared to be scheduled in advance. See id. at 3–4.
reduce the activity.

The removal of a company’s flexibility to make unexpected and urgent grants on dates that are not pre-fixed is open to criticism. Therefore, this proposal should be coupled with an alternative option that allows for unscheduled grants to executives, if these grants are reported within twenty-four hours of the grant date instead of the current forty-eight hour deadline set in the Securities Exchange Act, as amended by Sarbanes-Oxley. This twenty-four hour reporting requirement should not be seen as a limitation, because if the grant is so urgent that it cannot wait until the next scheduled grant date, then the burden of meeting the twenty-four hour filing requirement should seem negligible. Furthermore, in the limited situations where a grant is unexpected and urgent, filing within twenty-four hours should not be problematic, given the simplicity of the electronic filing system. In addition, many companies already report grants within this time frame without problems. While the administrative and compliance costs may seem significant, the benefits to be derived from this option should be weighed against these costs. In most cases, it is likely that the benefits will far outweigh the costs, given the likelihood of reduced compensation expense, increased shareholder value, and a reduction in the risk of having to restate financials or litigate the issue. With this option in effect, backdated options will be more likely to stand out, enabling the SEC to focus its enforcement mechanisms in the right places.

B. The Securities and Exchange Commission Should Heighten Third Party Obligations

Another approach would be to allow investors to bring suit against the third parties that indirectly aided or abetted in the undisclosed backdating by turning a blind eye to the activity and not questioning, or even encouraging, nondisclosure. Under this alternative approach, the third parties could be required to include a representation in their

242. BICKLEY & SHORTER, supra note 2, at 25.
244. BICKLEY & SHORTER, supra note 2, at 24.
245. See TIMING OF STOCK OPTIONS, supra note 5, at 1.
246. BICKLEY & SHORTER, supra note 2, at 24 (describing the current enforcement mechanism as a “low payoff exercise”).
opinions delivered to shareholders (such as legal opinions or financial statement certifications) that the corporate records have been reviewed and that no undisclosed backdated options were found. Consequently, lawyers and accountants would likely monitor their clients’ granting patterns more closely in an attempt to avoid personal liability to stockholders.\(^{247}\) When lawyers and accountants are aware that public disclosures are false or misleading, they should not escape liability just because their acts are classified as aiding or abetting, as opposed to constituting a primary violation.\(^{248}\) Even though accountants, lawyers, and other professionals are not actively encouraging misstatements, or are not necessarily even aware of them, investors and regulators rely on professionals to review the transactions and promote full and fair disclosure.\(^{249}\)

Allowing investors to sue the third party professionals that aid in the undisclosed granting of stock options will have many beneficial results. First, allowing suits against lawyers and accountants, or requiring them to make additional representations, would encourage diligence on the part of these individuals.\(^{250}\) Second, this increased level of diligence will consequently lead to an enhanced awareness of the problems associated with backdating. Third, to avoid liability, the third parties are likely to recommend heightened internal controls to their corporate clients. These recommendations will boost investor confidence in the market.\(^{251}\) Fourth, this solution is consistent with the SEC's commitment to pursuing “not just those who perpetrate financial fraud, but the corporate gatekeepers who allow it to happen on their watch.”\(^{252}\) Fifth, shareholders are unlikely to oppose any additional costs that arise as a result of the extra liability third parties are encountering, because it benefits

\(^{247}\) See Sachdev, supra note 167.
\(^{248}\) Id.
\(^{249}\) Id.
\(^{250}\) See, e.g., Halloran, supra note 212.
\(^{251}\) See Lucci, supra note 86 (discussing the impact of the heightened controls required by Sarbanes-Oxley). It should also be noted that companies with heightened internal controls are generally less likely to file a late Form 4. See BICKLEY & SHORTER, supra note 2, at 23.
\(^{252}\) Press Release, supra note 132 (quoting Linda Chatman Thomsen, the SEC's Director of Enforcement).
them in the long run.\textsuperscript{253} Finally, this solution would help circumvent the SEC resource issues because the third parties would be assisting the SEC in its initial stages of its investigations. In particular, this solution could prove extremely effective in the private sector, where the public does not have access to the financials to investigate the issue themselves.

\textbf{VI. CONCLUSION}

Stock options are a useful compensation tool that can provide huge incentives to employees, such as the opportunity to share in the employer's profits.\textsuperscript{254} Companies, however, are tempted to abuse stock options by manipulating grant dates to provide the maximum incentives to employees while minimizing the cost to the company.\textsuperscript{255} As the law currently stands, so long as backdating is disclosed, it is not illegal.\textsuperscript{256} Nevertheless, many backdated options still remain undisclosed, potentially causing extreme harm to shareholders.\textsuperscript{257} The current regulations have curtailed the problem, but they have not eliminated it completely.\textsuperscript{258} This is primarily because some companies are undeterred by the regulations and the SEC is unable to take enforcement action against more than a fraction of the companies that have backdated.\textsuperscript{259} Although there is a need for heightened regulation, it is unlikely that it will be enacted without opposition from those who fear excessive government intervention.\textsuperscript{260} Furthermore, if the SEC cannot afford to enforce the current laws, then the new regulations will be unsuccessful.\textsuperscript{261}

The objectives highlighted in this comment can be achieved by requiring fixed grant dates and by increasing obligations on the part of lawyers and accountants. The proposals set forth in this comment help to bridge the gap

\textsuperscript{253} See supra Par IV.C (discussing the benefits that could be derived from additional regulation).
\textsuperscript{254} See BICKLEY & SHORTER, supra note 2, at 1.
\textsuperscript{255} Kaufman, supra note 1, at 47.
\textsuperscript{256} Id. at 48.
\textsuperscript{257} See Maremont, supra note 9.
\textsuperscript{258} Heron & Lie 2007, supra note 87, at 294.
\textsuperscript{259} BICKLEY & SHORTER, supra note 2, at 20–21.
\textsuperscript{260} See Zea, supra note 168.
\textsuperscript{261} See Heron & Lie 2007, supra note 87, at 294.
between suspicions of backdating, and actual investigation and enforcement.\textsuperscript{262} The proposed regulations will significantly increase awareness of the backdating problem. In turn, heightened awareness will lead to both self-regulation on the part of the companies and to a promotion of critical practices on the part of lawyers and accountants.\textsuperscript{263} Finally, the benefits that the stockholders will reap from access to accurate disclosures, as well as stock values that reflect public confidence in companies with strong internal controls, should quell any opposition to this minimal level of government intervention.\textsuperscript{264}

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\textsuperscript{262} BICKLEY \& SHORTER, supra note 2, at 20–21.
\textsuperscript{263} See Heron \& Lie, supra note 59, at 7.
\textsuperscript{264} See Bennett, supra note 237 (discussing the benefits of regulation); Lucci, supra note 86 (concluding that strong internal controls boost the public’s confidence in the market).
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