

# Will stock options backdating scandals come to Canada?

By Nadine Côté



The scandals surrounding the backdating of stock options continue to mount in the United States. In testimony before the Senate Committee on Finance, the director of the Division of Enforcement of the U.S. Securities and Exchange Commission (SEC) revealed that as of September, this division was investigating over 100 companies for possible fraudulent reporting of stock option grants. The Justice Department has also laid criminal charges against several companies, and the Internal Revenue Service has served subpoenas on these companies and their executives. Businesses under investigation include Fortune 500 companies and smaller cap issuers, with news headlines naming prominent businesses and their leaders at Home Depot Inc., Microsoft Corporation and Apple Computer Inc.

The companies subject to these

inquiries have seen their stock prices plummet, have had to restate their earnings and are facing lawsuits from shareholders. In addition, directors and compensation committee members have been forced to resign and may face civil charges from the SEC. Executive dismissals have reached the highest echelons within organizations to include dismissals of their CEO, CFO and general counsel. For example, Comverse Technology Inc.'s CEO, CFO and general counsel are all subject to a civil injunctive action filed by the SEC alleging that they engaged in fraud and other securities laws violations in backdating stock option grants.

## Why backdate stock options?

Stock options are intended to be long-term incentive compensation for executives that aligns their interests with those of shareholders. A stock option gives its holder the right to purchase the stock underlying the option at a predetermined price – the “exercise price”. To act as an incentive for long-term future performance, stock options are granted with an exercise price at least equal to the market price of the stock underlying the option. Having these stock options motivates an executive's future performance to increase the market price of a company's stock. As the market price of the company's stock rises, the executive can exercise the option at the lower exercise price and

acquire and then sell the underlying stock. In doing so, the executive realizes a gain (the “in-the-money” amount) in the difference between the exercise price of the option and the market price of the underlying stock. Granting stock options with an exercise price at least equal to the market value of the underlying stock also ensures compliance with securities laws and the most favourable tax and accounting treatments.

Backdating stock option grants to create a reduced exercise price reflecting the stock's earlier lower market price creates an immediate paper gain that can instantly be materialized by exercising the option to acquire the underlying stock and then selling it. If undetected, backdating creates the appearance of having provided executives with long-term incentive compensation and complying with securities laws and the tax and accounting requirements necessary to achieve the most beneficial treatments.

## How does backdating work?

The methods allegedly used for backdating stock options are varied. The most basic method is to change the effective grant date of the option to an earlier date when the company's stock price was less than its current price. More creative means also exist

Comverse Technology allegedly created a pool of grants for fictitious employees when the company's stock price was low,

and then altered the records and substituted the names on the grants with the names of new hires. At times when the company's stock price was rising, new hires benefited by receiving options at lower exercise prices.

Brocade Communications Systems Inc. is said to have pushed forward the start dates of some executives to a time when the company's shares were trading at lower prices, so the options they received upon “joining” had lower exercise prices. Apparently, new employment letters with later hire dates were even inserted into their files. The company is also said to have granted stock options to employees on their acceptance of job offers on the basis that they were immediately commencing “part-time” work, rather than waiting until the individual actually commenced working. These part-time work arrangements were a sham because the employees did not work for the company yet benefited from option grants with lower exercise prices in place at the time of hiring.

## Consequences of backdating

Backdating grants of stock options defeats their intended purpose of aligning the long-term interests of executives with those of shareholders. Furthermore, this practice runs afoul of various securities laws and of tax and accounting requirements that provide beneficial treatment of stock options only if they are granted at least at fair market value. Companies and executives involved in backdating can face a myriad of legal, tax and accounting consequences, as outlined in some of the examples mentioned at the beginning of this article.

## Is Canada at risk?

To my knowledge, no options backdating scandals have yet hit Canada and, given our different regulatory requirements, it is less likely that they will. The options backdating scandals being investigated arose in the United States before the August 2002 implementation of the *Sarbanes-Oxley Act of 2002* (S-OX). Before S-OX, the SEC's required public disclosure filings informing investors of option grants were not due until 45 days after the company's fiscal year-end. This provided time to manipulate and backdate internal records before publicly disclosing the grants. However, with the implementation of S-OX, grants of stock options must be disclosed within two days, thereby greatly reducing the ability to backdate internal records.

The TSX requires that option grants be reported to the TSX within 10 days of the end of the month in which the grant was made. In addition, some securities laws require reporting issuers to file a report on the system for electronic disclosure for insiders (established by the applicable securities regulatory authorities) within 10 days of any change in the direct or indirect ownership of securities of the issuer, including options. These safeguards reduce the time frame in which companies could alter internal records to backdate stock options. We expect that these measures, along with Canada's accounting and tax requirements, will reduce the risks of backdating here.

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