STOCK OPTIONS BACKDATING SCANDALS: What do market participants think about the investigations?

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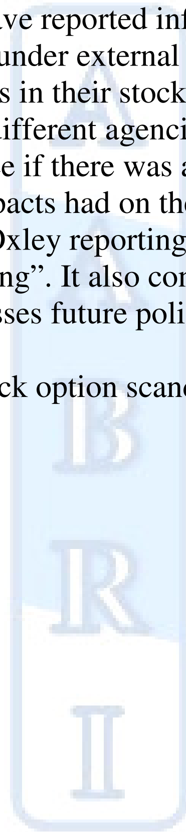
Abstract

Recently financial newspapers have reported information relating to stock options backdating. Over one hundred firms are under external investigations. Executives have been forced out and required to forfeit millions in their stock options while some took voluntary retirements. These events are related to different agencies taking second looks at executives' activities surrounding stock options to see if there was any wrong doing on the executives' parts. This paper explores the investigative impacts had on the investors. Increases in headline news were exacerbated by the new Sarbanes-Oxley reporting requirements. The paper confirmed what think tankers call "much ado about nothing". It also concluded that stock option accounting continues purification process and discusses future policy implication.

Keywords: Stock option backdating, stock option scandals, stock option investigations.



Introduction

Just as the nation is getting ready to put the news of WorldCom, Tyco, Enron and other corporate debacles behind them do the business community find itself embroiled in corporate stock option backdating scandals. The national concern about this practice has been spurred by series of articles in several news media including the *Wall Street Journals* from 2006 to date. The granting of stock options by itself are not illegal (Ciesielski & Weirich, 2007, Atkins, 2007 and Meyer, 2006) but the timing might be questionable. Rather, it helps to align managements' interests with those of shareholders. These financial scandals have shown no sign of abating given that several investigations have been launched by governmental regulatory agencies since 2006. These efforts are intended to mitigate executives' greed and reduce impacts of speculative investors.

It was reported on the *Cable Network News and World Report* on October 15, 2006 that over 157 firms were being investigated by different agencies, 16 executives have been forced out of their offices and 35 took voluntary retirements. Vanessa Futrmans reported on *the Wall Street Journal* of July 3, 2008 that UnitedHealth agreed to pay $912 million to settle suits brought by the SRC. It was also reported that an ex-Maxim executive paid $800,000 to settle civil suit with the Security and Exchange Commission in 2007. Brocade also settled civil suit in 2007 for $7 million based on Security and Exchange Commission investigations without admitting or denying the allegation in the complaint.

The researchers have not found any literature that directly gauged the market participants' reactions to the announcements of these investigations. This research draws on the market efficiency and expectancy theories. The theory is that market participants will not buy stocks of the firms being investigated if they do not see values on the actions being taken by the investigative agencies. Therefore, the stock prices of the firms will decline. This research investigates the reactions of market participants to the announcements of external investigations of firms that were suspected of engaging in stock option backdating. These actors are the movers and shakers who determine if firms should be restructured or allowed to die; measuring their reactions to these investigations is pertinent.

In order to address the theories above, the relevant literature will be reviewed followed by the development of a theoretical framework and testable model. The methodology and findings will them be presented followed by discussions of implications and conclusions. This research will provide guidance to policy makers and stockholders confronting stock option scandals while contributing to the literature on investors' reactions to stock options backdating scandals.

Literature Review

Stock options backdating scandals leading to top officials of corporations having to lose their jobs have become familiar and constant headline news. Many of these companies are being investigated by the Internal Revenue Service, the Security and Exchange Commission and others are being scrutinized by Justice Department and other interested agencies for what some are calling breach of fiduciary duty, an institution's violation of the duty of care (Meyer, 2007 and Lee 2007). It was reported on the October 12, 2006 of the *Wall Street Journal* that five top officers at McAfee and CNET Networks including their CEOs were the latest casualties in

accounting errors for stock-option expenses. These so called errors are costing executives jobs and money. The UnitedHealth's top two officials agreed to forfeit some $390 million in stock-option pay according to a report on November 9, 2006 issue of the *Wall Street Journal*. UnitedHealth is one of the largest companies to be ensnared in the option-backdating scandal, in which firms manipulated the dates that options were awarded to provide additional compensation to executives.

Some of the executives' actions have been referred to as option timing abuse and abuse of commitments to shareholders believe that options would have exercise prices equal to market price at the date of grant. Others call the actions of the top managements an outright misconduct. Some of the targeted companies' directors who oversee option backdating have suffered irreparable blows to their reputations affecting their future careers. They have also forfeited stock options amounting to billions of dollars in order to appease the stakeholders and had pledged their corporations to the investigating agencies.

Stock Option Grants

From early 1990 to 2003 major firms increased the average number of shares set aside for equity incentive grants from 8 percent to 17 percent of shares outstanding. Between 1980 and 2000, options were beloved by employees and stockholders alike, as a high-performing stock market made investors wealthy and grants evermore lucrative for executives. Corporations enjoyed the benefits as well. The options granted at fair market value were seen as "easy money" incurring no charge to firm earnings, while offering employees the opportunity for unlimited gain on which the firm generally received a tax deduction. This practice of pending stock options has lead to what some are calling corporate misconduct in the form of option backdating (Ciesielski & Weirich, 2007). Stock option grant by itself is surely not illegal but the timing of the grants might be questionable (Atkins 2007 and Meyer 2006).

Stock Option Backdating

A review of the current literature indicates that stock options could take many forms but not limited to the following: backdating can be defined as the act of retroactively shifting back the date of option grant to date prior to a lower stock price (Meyer, 2006 and Lee, 2007). This act does create an instant paper profit for the holder of the option. Granting of options immediately following the release of grim news when the stock price has been down is known as bullet dodging. When option grant is authorized with an exercise price below the selling price on the date of grant, it is called a discount option. It is also known as an option that is issued below fair market value (Meyer, 2006).

An exercise backdating occurs when the date of purchase is moved to an earlier or later date with a lower stock price to reduce the taxable gain realized upon the option exercise. Options that have an exercise price equal to the stock price on the date of grant are called fair market value option. When one holds the option in abeyance for a period of time, waiting for the stock price to dip is called forward pricing. Granting stock options shortly before an announcement of good news that will influence firms stocks positively is called spring loading. The investigations are focused on stock option backdating which can be defined as retroactively moving back the date of grant for an option to a prior date with a lower stock price (Lee, 2007).

The exercise backdating which retroactively moves the date of exercise of an option to an earlier or later date with a lower stock price can reduce the taxable gain realized upon option exercise. Stock option backdating effectively results in discounting the stock price because the exercise price is lower than the fair-market value on the true date of grant. This practice creates options with immediate paper profit for those that benefited from the grants (Meyer, 2006).

Sarbanes-Oxley Act of 2002

These investigations and the headline news stock options backdating have stirred might be as a result of changes in equity assignments to executives and reporting changes from Form 5 to Form 4 being enforced under Sarbanes-Oxley. Before 2002, there were few barriers to backdating options. Security and Exchange Commission (SEC) required that options granted to executives be reported once a year on form 5 even up to 45 days after the end of the firm's fiscal year (Walker, 2007).

The change being enforced under the Sarbanes-Oxley legislation requires firms to use Form 4 and to file with SEC within two business days of any equity grant to an executive officer. The need for prompt filing is meant to limit the ability of companies and executives to manipulate grant dates. Many firms have failed to meet the recording requirement due to old habits, unintended mistakes. Thus causing investigative agencies to find out the reason behind reported delays (Rosen, 2006).

Theoretical Framework

The analytical review of this paper grows out of the theoretical frameworks of the efficient market and expectancy theories. Therefore the investors' impressions of announced investigation of companies suspected of backdating employer stock options will be gauged based on efficiency market and expectation theories. When traders talk perspectives, they are looking for indications whether to buy or sell securities. Some events always guide them in the decision making process including but not limited to availability of market information, acts of the companies' executives, the companies' future investment plans, etc. According to expectation theory, if the market is efficient many participants in the market would buy a given security if the future prices are expected to be higher than the current price. If individual risk tolerances are ignored, expectation theory is an unbiased instrument in measuring future spot rates (Lars, 1980). It is also assumed that the freely available market information in the marketplace is unbiased. However, the efficient capital market hypothesis and the anomalies are yet to be resolved (Fama, 1998).

Some academicians are adhering to market efficiency theory while others believe in behavioral finance, and many are still not convinced that either side has substantive plausibility (Ross et al, 2007). There is no question that securities' market information is readily available in U.S. markets. The academicians' viewpoints are that conservatives are slow to react to news while representatives act quickly to news (Ross et. al, 2007). Also, questions have been raised as to why investors overreact to any Internet bad news but do not react quickly to earnings news. The answer might be based on human behavior, including individual values, risk tolerances and expectations.

Data, Results and Analysis

Data

A report on the *Wall Street Journal* in October 12, 2006 indicated that nearly 153 companies are internally probing stock options backdating. At least 130 companies are facing external investigations, says a report on the *USA Today* November 14, 2006. To conduct this investigation, 100 company names were obtained encompassing those that were being investigated by external entities. It was determined that some of these companies have been either merged or bought out while others did not have necessary data to be included in the research. Some of the investigative announcements occurred several years ago, making it hard to obtain the necessary data. These led to a decision to utilize only firms that investigative announcements were announced in 2006, thus limiting the number of firms for which data was collected to 65. The periods of the announcements covered were from May 9, 2006 to October 30, 2006. Yermack and Liu (2007) used one year (2006 tax information) to determine ownership of executive houses to study relationship with CEOs' house purchases and subsequence of company performances. Traders' emotions sometimes do control their short and long term goals. Peoples' actions are many times controlled by their frontal lobe of their brains deal with peoples' quick actions. It is like going into a voting boot and when the curtains are closed, the voters' decisions are influenced by current events. Therefore, short-term data can be used to gauge traders' reactions to stock options scandals that led to agencies investigations.

The data used in this study covered four months (40 days) trading periods, two months (20 days) trading stock data before announcement of any investigation and two months (20 days) trading data after the announcements. Stock price data of the investigated firms were obtained to gauge what reactions if any by the market participants at aggregate level. The stock prices of the firms were obtained from the *Wall Street Data Base*.

Data Treatments

The collected individual firm's 40 days data were aggregated over the period. Percentage changes in the data were obtained to gauge activities of market actors during these periods. The treated data were used for experimental analysis purposes. The percentage changes in the aggregate data were used in the graphic depiction as the market participants' reactions in the trading of stocks. This is necessitated due to the inability to extract appropriated market indexes to run regression that will produce some parameters like a t-test or covariance.

Results

Figure 1 is graphical depiction in percentage changes of 20 days trading before any investigative announcements were made. The noticeable variations occurred two weeks before the apparent announcements but stabilized over few days before the actual announcement occurred.

Figure 1

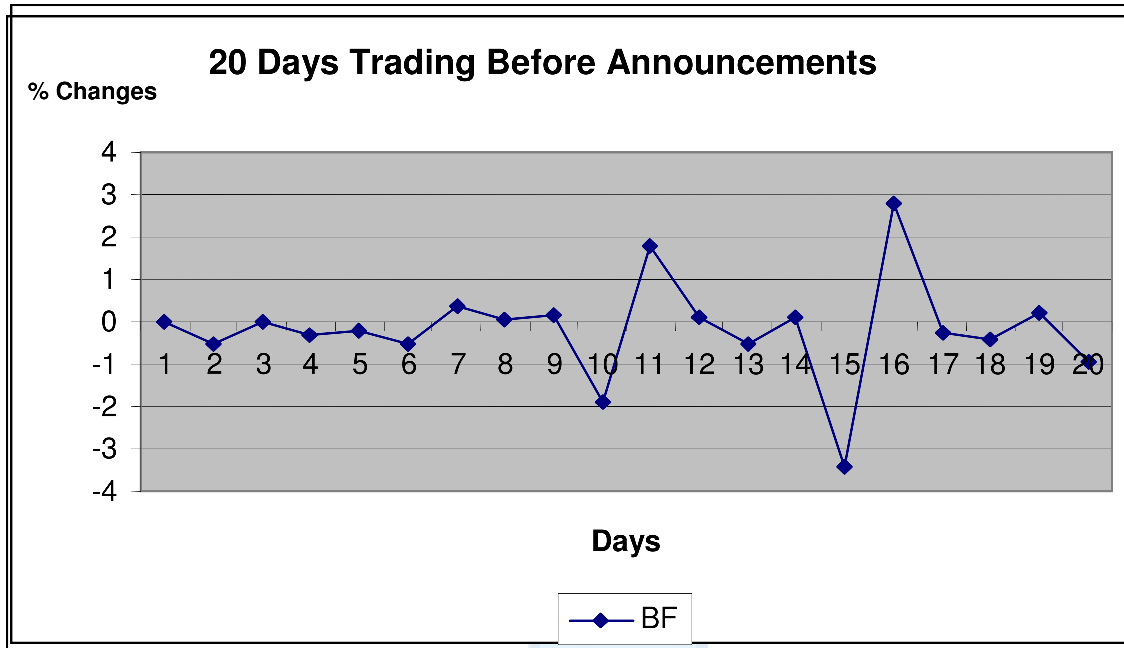


Figure 2 indicates a graphical depiction of 20 trading days after investigative announcements occurred. Critical observation of the percentage changes graphed showed that there were no immediate negative reactions by the traders following the investigative announcements. Rather, there were positive reactions up to three weeks following the announcements. There was a sharp decrease on the fifteenth day followed by an upward swing on the next day that could not be explained.

Figure 2

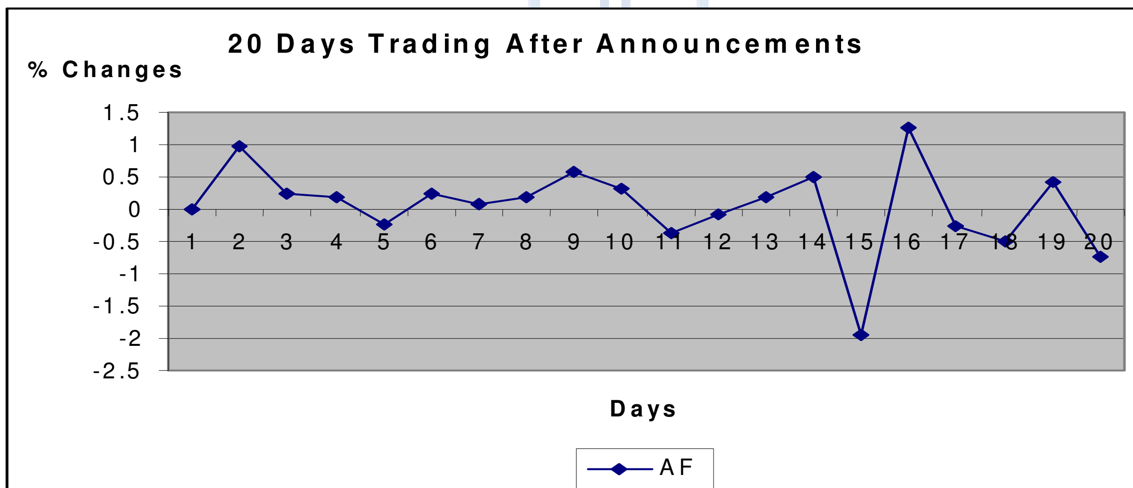


Figure 3 shows superimposed depiction of before and after 20 days trading activities before and after the investigative announcements. It can be stated that the after investigative data were steady compared to the before data. This might be an indication of trust and faith that the traders have on the action of the investigation agencies.

Figure 3

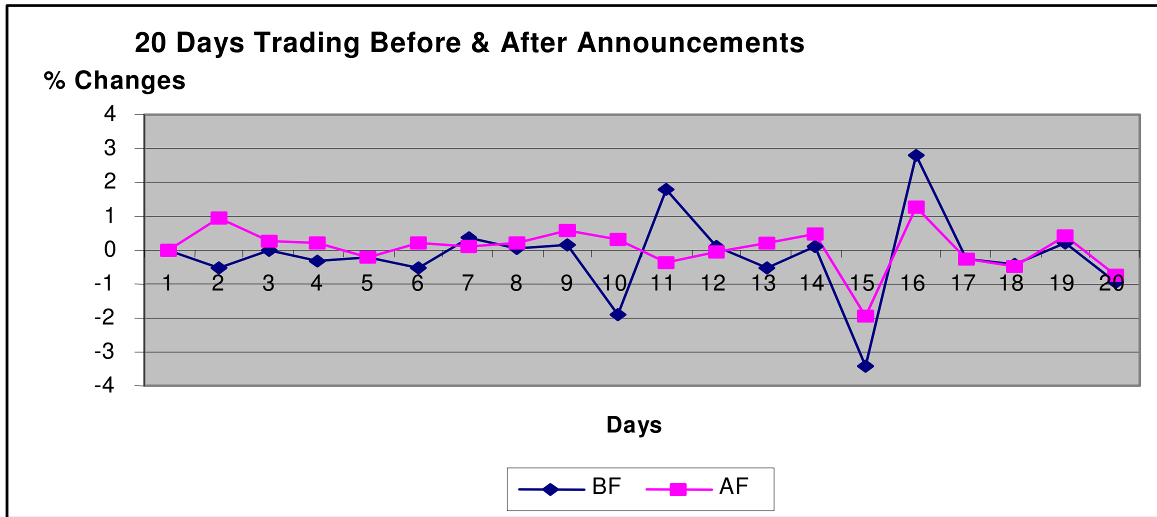
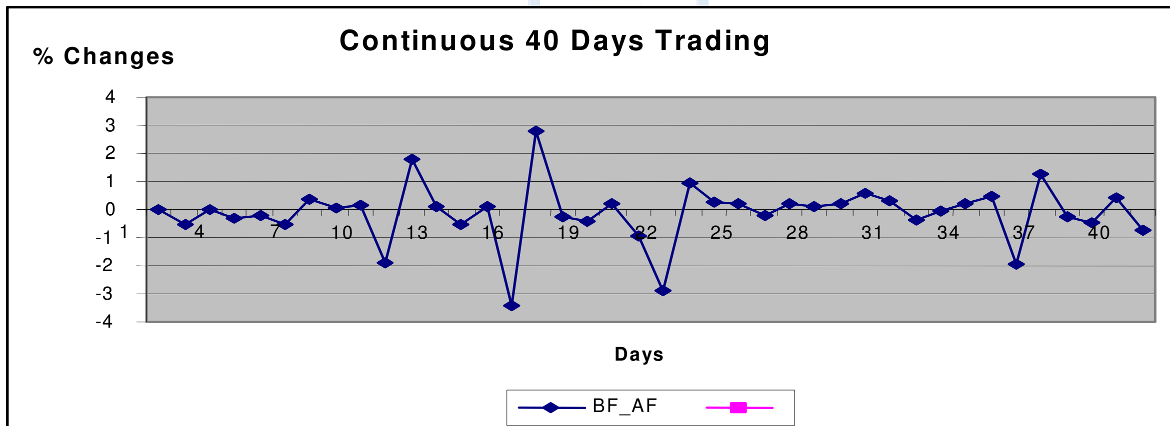


Figure 4 shows the percentage continuous graphical depiction of 40 days trading activities. The graph shows erratic trading days before the announcements compared to the trading after the investigative announcements were made. The after trading data indicated that the market actors saw value to the intended actions of investigative agencies.

Figure 4



Below are the compressed obtained data, date covered and their percentage changes.

Table 1
Selected Stock Options' Data Aggregate and % Changes
Dates of Announcements: May 9, 2006 to October 30, 2006

Days Before	*Aggr. Price*	*% Changes*	*Days After*	*Aggr. Price*	*% Changes*
20	1851.17	0	***1***	1733.92	-1.08054
19	1840.18	-.598679	***2***	1750.66	.965442
18	1839049	-.037496	***3***	1754.97	.246193
17	1832049	-.38054	***4***	1758.42	.196585
16	1827.53	-.27067	***5***	1754.34	-.232026
15	1816.77	-.058877	***6***	1758.38	.230286
14	1822.55	.318147	***7***	1759.81	.081325
13	1822.24	-.01701	***8***	1763.13	.188657
12	1824.57	.127865	***9***	1773.31	.577382
11	1788.75	-1.963203	***10***	1779.08	.32538
10	1819.90	1.74144	***11***	1772.42	-.374351
9	1820.59	.037914	***12***	1771.18	-.069961
8	1809.50	-.609143	***13***	1774.52	.188575
7	1810.39	.049185	***14***	1783.17	.487456
6	1747.42	-3.478256	***15***	1748.62	-1.93756
5	1795.41	2.746335	***16***	1770.64	1.259279
4	1789.31	-.339755	***17***	1766.16	-.252846
3	1780.45	-.0495163	***18***	1757.44	-.493896
2	1783.48	.170182	***19***	1764.62	.408549
1	1765.80	-.99132	***20***	1751.43	-.74747

The only foreseeable trading activity seems to be unconnected to the investigation announcements are deep falls in the prices of the stocks five days before announcements and fifteenth days after the announcements. It can be stated that graphical depictions indicate that there are no negative (significance) impacts of investigative announcements based on the price of firms' stocks. Rather, 10 days trading market data after investigative announcement were slightly higher than 10 days market data before the announcements. This is an indication that investors saw value in the actions being taken by the investigators. Human finance may be blamed for any unanticipated reactions to such announcement given that some see values due to investigative actions being taken. Others will believe otherwise and some might argue that the investigation is much to do about nothing. Others may argue that the investigative actions were another way to redistribute wealth from the executives to governments and stockholders.

Discussion

Investor reactions have been muted despite a string of criminal indictments and high-profile resignations (Guynn, 2006). Individual investors are hoping that these investigations would stop the possible and anticipated abuses of stock option backdating from occurring. By stopping the abuses, firms will report higher incomes by reducing the money that would have gone to the executives after they exercised the options. This would result to higher revenues for firms, higher taxes for governments and perhaps higher dividends for the stockholders.

The efficient market theory purported that because market information is readily available, the current price of a given security will reflect any bad or good news on the horizon. Thus, it is expected that stock prices of companies that were under scrutiny or involved in scandals will be selling at lower prices after the announcement of any investigation(s). However, if buyers see the investigation as purposeful actions that will affect positive behavior, they will buy more of those stocks. This is because investors believe that the act will strengthen the firm and thereby their future earnings. On the other hand, should the market participants see that the investigation(s) would not help but harm the firms they would unload their stock to limit their losses. Thus, the market participants are watching with interest many of the companies that have appearance of stock option manipulations. This is because many of these firms are facing costly measures including but not limited to accounting restatements, litigations by stakeholders, security and exchange commission and Justice Department investigations, and some directors may be terminated. The investigations have affected the continuity of some of the firms' management and performances hopefully for better in the long run.

Conclusions

Stock options are incentive programs established by board of directors and top executives to influence task performance, work ethics, and efficiency of top management of corporations and were never meant to be abusive. This paper ascertains that overall the investigative announcements did not negatively influence the stock prices of the pertained firms. Rather, it can be stated that failing to meet the newly required reporting time table as prescribed by the Sarbane-Oxley Act of 2002 have led agencies to raise questions about the real reason behind the delays. Option granting practices between 2002 and 2004 often failed to comply with the Sarbanes-Oxley requirement that grants of awards to executives be reported within two days of board approval (Rosen, 2006). The 2002 passage of the aggressive corporate reforms act *(Sarbanes-Oxley)* significantly sped up how quickly companies must report stock-options grants. Failure to comply has increased the number of launched investigations by federal agencies.

It is also hoped that these investigations might lead to clearer understanding of inappropriate accounting issues by the executives that will enable them to take quick steps to guide against future abuses. The investigations have exacted enormous costs to the companies ranging from taking charges to restating of their financial statements for two to three years. Several executives have stepped down from their jobs, others fired and many gave up their options amounting to several billion dollars. Even company lawyers have disgorged millions ranging from civil penalties, interests and options exercised. However, the investigations have created jobs for lawyers to help firms sort things out. All this leads to a form of revenue redistributions from the executives and company lawyers to agencies in the form of fines, to stockholders in the form of healthier companies, and governments in the form of higher tax revenues resulting from higher profits to the companies. The government's deficit may be lowered from the redistributed revenues, an unintended result. Accountants might have to restate earnings, and the alternative minimum taxes individuals pay might be changed due to redistribution of earnings. These unintended consequences of the 2002 Sarbanes-Oxley Act will keep the Security and Exchange Commission busy for the foreseeable time. At the mean time, the accounting standard to deal with stock option backdating continues to undergo purification.

Most of the writings on the stock option scandals have come from newspapers without full market data to support the claims being made. This paper ascertained the reactions of investors (thought not all firms were included) to the various investigative announcements using market data thus, has contributed to stock options backdating literature. If and when market indexes become available, firms could be truncated into markets in which they trade in order to obtain parameters for predictive purposes.

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