

# The Ethics of Stock Option Backdating

BY JANINE DUSOSSOIT

ON A SIZZLING JULY AFTERNOON, Suzanne Winters was happy to be ensconced in her air-conditioned office at CatRx. As the IRO for a small technology firm, she had worked hard the past year to increase visibility with institutional investors and had succeeded in getting two new sell-side analysts to pick up coverage.

Her efforts seemed to be paying off. Over the past 12 months the stock had climbed 25 percent — and on the quarterly conference call last week, management had expressed confidence for the second half of the year. With the 10Q now filed, Suzanne had a little time to breathe and in the cool of her office picked up *The Wall Street Journal*. She was immediately deflated. On the front page was yet another account of a corporation that was under investigation by the SEC for stock option backdating.

She resolved to take the initiative and marched down to the CFO's office. "Did you see this morning's paper?" she asked. "Another high-tech company is in hot water with the SEC and announced it is restating its earnings because of questions about the timing of stock option grants."

"I know. It's incredible how this scandal is spreading," said CFO Jack Abacus as he sipped his coffee.

"Jack, I believe we ought to do an internal investigation to be sure that our house is in order. We don't want to end up in a similar situation," said Winters.

"What?" he said, looking up suddenly and spilling his coffee. "We grant stock options the same time every year, except when there's a new hire and that person receives an initial grant. Are you insinuating that someone at CatRx manipulated the dates of its grants?" he questioned, his voice rising with anger.

"Well, yes, that's true. But everything has been going so well, and I would hate for us to get tripped up by a situation we weren't prepared for," she said. "The last thing we want is to have to delay an SEC filing because of any investigations."

Suzanne continued, "You know our stock tends to be volatile, and we've used stock options pretty liberally to attract talent and as an incentive for management. Something might look suspicious to an outsider who may not know what our standard procedure is for granting options. I recommend that we start by plotting the dates of all grants for the past 10 years against the stock price. That should reveal any periods in which grants were made right before the stock rose sharply, especially when the jump could be attributed to favorable news, for example."

Abacus reluctantly agreed. "I hope the legal department doesn't insist on issuing a news release announcing that we're doing an internal investigation," he said. She shook her head. "No, but I'll need their help to assemble the data," she added.

That afternoon, the general counsel notified the CEO and the chairman of the compensation committee that the company was conducting the analysis as a precaution. The following day, Winters collaborated with the assistant general counsel to gather the necessary data. In addition to plotting the grant dates against the stock prices, they looked at the dates and exercise price of grants to confirm that they corresponded to the actual grant dates and closing prices of the stock that day. She also prepared a Q&A for management to review. Given the rash of news stories about high-tech companies being targets of SEC investigations, it was reasonable to expect that one of their analysts or investors might inquire about the company's stock option policies.

Backdating of option grants, Winters knew, is not in and of itself illegal, as long as proper corporate procedures are followed and the backdating is disclosed. Failure to do so, however, would likely constitute securities fraud and could be considered a material omission with respect to executive

integrity noun or ethical strength of being hon

compensation information required in the proxy statement for the annual meeting.

In 2002, prompted by Sarbanes-Oxley, the SEC put into effect a rule that executive stock transactions, including option grants, must be reported to the agency within two business days on Form 4. Prior to that time, companies didn't have to report option grants until months later. Winters also learned from the CatRx tax department that

backdating options could cascade into tax return errors.

It didn't take Winters and her general counsel long to prepare a presentation of their findings to senior management and several members of the board of directors. As they practiced a dry run of their slides, Winters felt confident that she had proffered the correct argument that prompted the internal investigation.

After all, she was the holder of a considerable number of CatRx shares as well as options. Her company was performing well, and management had trusted her judgment.

Being proactive had saved Winters and her company's management and board many sleepless nights. Now they could look ahead with no reservations. [IRU](#)

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