Study Links Options Backdating to Corporate Governance Weaknesses

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Harvard Professor Lucian Bebchuk and colleagues use a new method of identifying CEO and outside director manipulation of stock option timing and assert correlations to governance problems.

SocialFunds.com -- Back in 2004, many companies were arguing *against* a Financial Standards Accounting Board (FASB) rule mandating stock option expensing (or reporting the estimated value of outstanding options, since the exact value is not determined until options are exercised.) In February of that year, University of Iowa Professor Erik Lie submitted his now-celebrated study that broke open the options backdating scandal (for which 120 companies have by now come under scrutiny) upon its May 2005 publication in *Management Science*. Talk about duplicity--many companies claimed the value of options is too difficult to calculate with precision (and so their value should not be reported at all) while executives were busy calculating when to retroactively exercise options to reap windfalls stolen from shareowner value.

The idea of manipulating stock option timing was first introduced in a 1997 paper by New York University Professor David Yermack. A few papers followed, with researchers scratching their heads over how executives could possibly predict the fortuitous stock movements reflected in the statistical anomalies of exercise timing documented in their research, until Prof. Lie surmised the unthinkable. Perhaps these fortunate executives were not predicting the future but rather tracking the past--a supposition Prof. Yermack had trouble believing at first because the "whole idea was so sinister," even in the post-Enron world when executive fraud was exposed as widespread. A flurry of academic activity has followed, mostly looking at stock price patterns before and after options were exercised (in addition to the investigative activity and string of executive resignations and dismissals spurred by the findings.)

Now Harvard Professor Lucian Bebchuk and colleagues have taken the next step of correlating option manipulation with corporate governance strength (or, more precisely, weakness.) This is the same connection asserted by the socially responsible investing (SRI) community in demanding option expensing as a form of strong governance. Also, Prof. Bebchuk and Yaniv Grinstein from Cornell and Urs Peyer from INSEAD introduce a new method for identifying what they facetiously call "lucky" options--those granted at the lowest price of the month (and hence guaranteed to rise in value.)

"Lucky grants were more likely when the company did not have a majority of independent directors on the board and/or the CEO had longer tenure--factors that are both associated with increased influence of the CEO on pay-setting and board decision-making," the authors write. "These findings are consistent with the view that grant date manipulation reflects governance problems."

The November 2006 paper, entitled *Lucky CEOs*, also examined the scope of the scandal, estimating that about 1,150 lucky grants resulted from manipulation and that 12 percent of public firms (720) provided one or more manipulated lucky grant between 1996 and 2005. As if "lucky" grants were not bad enough, the study finds about 1,000 "super-lucky" grants awarded at the lowest price of the calendar quarter, about an estimated 62 percent of which were due to manipulation.

To underscore the connection between management and boards in option manipulation, the trio issued a companion paper, *Lucky Directors*. The December 2006 study finds outside directors at seven percent of firms received manipulated lucky grants during the 1996 to 2005 period.

"We estimate that about 800 lucky grant events owed their status to opportunistic timing, and that about 460 firms and 1,400 outside directors were associated with grant events produced by such timing," they write in the paper.

They also document a correlation between director "luck" and poor corporate governance.

"Grant events were more likely to be lucky when the firm had more entrenching provisions protecting insiders from the risk of removal [and] when the board did not have a majority of independent directors," state the researchers in the paper. "And outside directors' luck was correlated with CEO luck."

"The Sarbanes-Oxley Act (SOX) reduced the incidence but did not eliminate the opportunistic timing of directors' grants," they add.

Unfortunately, even the flood of research on options backdating will not necessarily result in justice.

"I believe that only a minority of firms that have engaged in backdating of option grants will be caught," says Prof. Lie on his website. "In other words, we will never see the full iceberg."

Prof. Lie cites two reasons. First, backdating can be hard to identify.

"[Second, both] the regulators and the investment community might be content to set some precedents based on a limited set of backdating cases to send a signal that backdating and similar behavior will be punished severely," Prof. Lie states. "In any event, resources will likely be put in place to improve the disclosure requirements for option grants and enforce existing regulations."