On Personal Finance | Options backdating: A scandal with wide reach

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As scandals go, the one concerning options backdating is... well, it's not exactly Enron-sexy. But it should be.

As a window into bigger issues concerning the way American companies are run, it concerns anyone who invests, or who worries about job security or the health of a pension plan that owns stocks. Democrats are sure to address it when they tackle sky-high executive pay after taking over Congress next year.

State and federal regulators' backdating investigations have mostly involved technology companies, where there have been plenty of wild and woolly practices. About 120 companies are under investigation, and dozens of executives already have lost their jobs.

But late last week, the picture changed, with release of a Harvard study, titled "Lucky CEOs," which found backdating among "old economy" firms as well as high-tech ones. It concluded that 720 companies - 12 percent of firms studied - had backdated options for about 850 chief executive officers between 1996 and 2005.

A typical stock option gives its owner the right to buy a share of company stock anytime over 10 years at a set "strike price." The option owner profits if he can buy shares at the strike price and sell at a higher market price. The strike price is usually the market price on the "grant date" - the day the company's board of directors gives the options out.

In backdating, the company picks an earlier date when the stock was trading at a lower price, thus reducing the strike price. This defrauds the firm's shareholders because the company receives less money for the shares than it should get.

The study focused on grant dates that occurred when each stock was at its lowest for the month and quarter the grants were made. It found more grants on these dates than coincidence could explain.

In effect, backdating gave those CEOs an undeserved raise of 10 percent.

What companies were prone to backdating?

"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 researchers wrote.

In other words, CEOs win because they have subservient directors who looked after the CEOs rather than the shareholders. The same perverse relationship explains why other forms of executive compensation also have soared in recent years while ordinary Americans' incomes have languished.

Though most such pay increases are legal, they divert money that should be used to benefit all shareholders - for dividends, research or expansion, for example.

Moreover, if CEOs have this kind of power, are they misusing it in other ways as well? Can they pressure boards to keep them on despite poor performance?

If the answer is yes, everyone suffers - shareholders, employees, pensioners...

Now, with the Democrats' taking control of Congress, there's hope for a partial remedy in the revival of a stalled bill introduced last year by Rep. Barney Frank (D., Mass.), who is expected to become chairman of the House Financial Services Committee.

The Protection Against Executive Compensation Abuse Act would dramatically improve public disclosure of executive compensation, including details of perks, pensions and golden parachutes.

Most important, it would require that shareholders approve executive compensation plans.

That ought to be a no-brainer, as shareholders are the owners. But business groups are sure to continue opposing the bill. They will argue, as they have in the past, that executive pay is not excessive - that it simply reflects the forces of supply and demand in a free market.

But why would a handful of directors on a compensation committee better reflect market forces than the thousands of people who own the company's stock? They wouldn't - the shareholders are a much more valid sample.

The issue of executive pay has festered for years, undermining Americans' sense of fair play. Now, with change coming in Washington, there's a real chance something will be done about it.