Will Backdating Scandal Thwart Effort to Roll Back Reforms?

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A few bad apples. That was the oft-heard line taken by corporate leaders back in 2002 and 2003, after the meltdowns of Enron, WorldCom, Tyco and Parmalat. A few miscreants, they argued, shouldn't be allowed to tarnish the entire corporate world.

But this year's backdating scandal has eliminated the last echoes of that defense. More than 120 companies have been implicated in what all but a few hardy holdouts now acknowledge is simple theft. As one former chairman of the Business Roundtable told me: "Those guys were caught with their hands in the cookie jar."

Clearly, something's amiss in the orchard. A new study out this week helps explain what that might be. Three scholars -- Lucian Bebchuk, Yaniv Grinstein, and Urs Peyer -- have run the numbers on 29,000 grants of stock options to directors, and found that 9% of them were "lucky" -- that is, they occurred on a day when the stock price hit a monthly low. "Lucky" is in quotes, because the authors clearly believe that many, if not most, were the result not of luck but of backdating.

Options were originally given to directors to align their interests more closely with those of shareholders. But the new study suggests in many cases that options have had a very different effect, tying directors more closely to management. "Directors' grant events were more likely to be lucky when executives, and especially the CEO, also received a grant on the same date," the study concludes.

One more finding of note: The "lucky" grants were more common in the days before Sarbanes-Oxley, which sets tight deadlines for reporting option grants. But they continued after the corporate-reform law was passed, suggesting the problem hasn't been solved.

The backdating brouhaha has occurred just as the business community is gearing up to roll back rules put into place after the 2002-2003 scandals. The Securities and Exchange Commission last week announced plans to relax Sarbanes-Oxley requirements for smaller companies. In addition, the Justice Department said it was revising some of the tougher prosecution practices it adopted in the wake of those scandals. And the Committee on Capital Markets Regulation, a private group acting with the blessing of Treasury Secretary Hank Paulson, recently recommended more sweeping changes, including measures to limit class-action securities lawsuits.

The prevalence of backdating raises the question: Has the corporate-reform movement really gone too far? Or has it not gone far enough?

Assemble a room full of CEOs and you will find no doubt that it has gone too far. They'll regale you with stories about the excesses of litigation, the terror tactics of prosecutors who threaten to indict entire companies and the pointless costs of Sarbanes-Oxley Section 404, which requires outside audits of companies' internal financial controls. Fill the room with unionists, shareholder advocates and academics, and you'll hear tirades against the inconceivable greed of CEOs, who

despite eight-figure paychecks feel the need to break the rules to make even more money.

In the midst of this rancorous debate, Ira Millstein, who has long labored in corporate governance, is the rare voice of sanity. Mr. Millstein, senior partner at Weil, Gotshal & Manges, rightly argues that some of the post-Enron reforms have gone too far. Indeed, he surprised and angered many of his left-leaning friends in academia and elsewhere by signing on to the report of the Committee on Capital Markets Regulation.

Many of those recommendations make good sense. Section 404 of Sarbanes Oxley was a classic case of legislative overreach, imposing excessive burdens on small companies, and discouraging foreign companies from listing shares in the U.S. The Justice Department's much-discussed "Thompson memo" was also the product of overreaction, allowing federal prosecutors to adopt the bullying tactics favored by New York's former attorney general, Eliot Spitzer. And class-action securities lawsuits, while not new, continue to be an overused tool. On all of these, some rollback would be welcome.

But in return for those changes, Mr. Millstein wants "the grand bargain." Instead of more regulation, more prosecution and more litigation give shareholders more power to oversee the companies in which they invest. Make it clear, once and for all, that directors really do work for shareholders, not for management, by giving shareholders the power not only to remove directors, but also to nominate them, without engaging in costly proxy battles.

The commissioners of the SEC are considering changes that move in this direction, and the business lobby in Washington has launched a determined battle to stop them. For corporate leaders, shareholder democracy may be a frightening prospect. But it beats the alternatives.