

# Dating games

The timing of executive stock-option grants is cause for investor—and regulator—concern

BY JOHN GRAY

**W**hile an ever-widening stock-option scandal south of the border has U.S. investors angry and worried, Canadian investors may be feeling a little smug. But that conceit may be premature, at least according to a new report suggesting that some of Canada's largest companies may also be manipulating the timing of stock-option grants to give executives bigger bonuses. An analysis of options granted over the past three years by Canada's 60 largest and most heavily traded companies shows a troubling pattern of share prices falling in the days before options are granted, followed by a sharp upturn shortly afterward. Says Sam La Bell, an analyst with Toronto-based Veritas Investment Research Corp., which produced the study: "While there may not be a smoking gun, there is a disturbing pattern that suggests that the timing of option grants is alive and well in Canada."

According to the Veritas study, stock prices for the 60 companies examined dropped an average of half a percentage point in the 10 days before options were granted and then rose more than one percentage point over the next 15 days.

**US\$500 MILLION AVERAGE LOSS OF VALUE AFTER BEING IMPLICATED IN OPTION BACKDATING**

**10 DAYS CANADIAN COMPANIES HAVE TO REPORT STOCK OPTION GRANTS**



"This trend suggests that management may be timing option grants to precede positive announcements or to follow bad news," the report states.

While Veritas did not single out any specific companies in its report, dozens of major U.S. firms have been caught up in a backdating scandal, in which executives received instant paper profits through options dated retroactively to an advantageous time. Apple Computer Inc., Home Depot Inc. and UnitedHealth Group Inc. have all said they may have to restate years of financial results after allegedly improv-

erly accounting for backdated executive stock options. A handful of company executives have already been forced to resign after admitting to backdating their stock options, and dozens of companies are now under scrutiny from the U.S. Securities and Exchange Commission and the U.S. Justice Department. Even the U.S. Congress began hearings into the scandal, in early September. Recently, executives at Brocade Communications Systems, Inc., and Converse Technology, Inc. were

▲ UnitedHealth CEO William McGuire

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charged with fraud in connection with the backdating scandal.

Stock options have been a popular carrot to dangle before senior executives. They are supposed to help align the interests of shareholders and executives by letting company managers reap the rewards of a rising stock price. An option gives its holder the right to buy a stock at a fixed, or "exercise," price. The lower the exercise price, the higher the potential for an executive to profit. Backdating occurs when options grants are dated retroactively to a point in time when the company's stock was trading lower than when the options were actually granted. As a result, executives make an instant profit—without having to do anything. Not only does this undermine the whole idea of incentive options, but it is also illegal.

Less clear-cut is the legality of other dating games that executives are accused of playing with their stock options. One tactic is "spring-loading," or granting options before releasing good news that is likely to drive up the company's stock. Another ploy is "bullet-dodging," or granting options after bad news has already driven down the stock price. While TSX rules forbid setting stock-option prices when the company is in possession of undisclosed material that could affect

its share price, the definition of what is material is not always so cut and dried. For instance, directors at Dofasco Inc. were criticized last year after granting themselves thousands of options, at about \$39 per share, while they were negotiating with a suitor that would eventually offer to buy the company for \$68 per share. Dofasco insiders made millions from their options, but so, too, did common shareholders when another company bought Dofasco for \$71 a share.

That's not the case when it comes to companies currently embroiled in the options backdating scandal. A University of Michigan study, released in August, estimates that companies implicated in backdating stock options lose an average of 8% of their value, or about US\$500 million per company.

It was not crusading regulators, governance advocates or even the much-feared

hedge-fund managers who touched off this scandal, but rather a dense academic study from the University of Iowa, published last year. In the study, finance professor Erik Lie found a strong correlation between option-grant dates and low share prices. "Unless executives possess an extraordinary ability to forecast the future market-wide movements that drive these predicted returns, the results suggest that at least some of the awards [were] timed retroactively," Lie wrote.

Not surprisingly, most of the options backdating occurred during the Internet boom of the 1990s, when many tech companies relied heavily on stock options to both attract employees and reward managers. A time lag between the dates the options were granted and when they were reported to regulators also helped to exacerbate the problem. That loophole was closed in 2002 with the enactment of Sar-



Former Converse CFO David Kreinberg (right) after arraignment for options fraud

banes-Oxley legislation in the United States that now requires companies to report option grants within two days.

To understand how lucrative that loophole was, just look at the compensation of William McGuire, CEO of UnitedHealth Group Inc., an insurance company in Minnetonka, Minn. Earlier this year, the company revealed that McGuire had accrued more than US\$1.6 billion in unrealized stock-option gains. Much of those gains came as a result of an agreement with the company that allowed McGuire to choose the dates on which his stock-option grants came into effect. Not surprisingly, McGuire chose dates around times when the company's stock hit its lowest point of the year. The odds of choosing those dates at random are about 200 million to one, according to an analysis published earlier this year by *The Wall Street Journal*. To put that in perspective,

the odds of correctly picking all six numbers in the Lotto 6/49 are about 14 million to one, while the odds of being struck by lightning are about 700,000 to one.

Canadian companies are required to report stock-option grants within 10 days. But that 10-day window still gives them enough time to backdate their options and other bonuses such as deferred share units that mimic stock options. For example, managers receiving a \$100,000 bonus in the form of deferred share units would get 10,000 DSUs of a company trading at \$10 on the date of the bonus. If, however, the award is backdated a week to when shares were trading at \$9, managers would suddenly see their bonus grow to 11,111 DSUs, giving them an instant profit for doing nothing.

While no Canadian companies have been implicated in the scandal yet, that doesn't mean they are not under increasing scrutiny. In early September, Canadian Securities Administrators released a notice urging public companies to audit their own internal options-granting policies to ensure they are in compliance with current regulations. "If CSA staff become aware, through disclosure reviews, tips or otherwise, of abuses by reporting issuers, they may take enforcement action against the issuers or their directors and officers," the bulletin warns.

That's a good start, but companies will have to do much more to restore the already shaken confidence of shareholders, says Bill Mackenzie, president of Institutional Shareholder Services Canada, a Toronto-based proxy advisory firm. Implementing "best practices"—such as increased disclosure of option-granting rationale, adopting fixed-option-granting schedules and "blackout" periods to preclude option grants when executives have material information that has not been disseminated to investors—can help to lower the chances of managers playing stock-option dating games. But shareholders still have to ultimately trust that company directors will ensure their interests are protected, says Mackenzie. "Without that trust, the only other thing shareholders can do is vote against all stock-option plans." □

