Stock option backdating

Optional deterrence

Are big fines the best way to fight stock option backdating?

By John Gray

John Gray is a senior writer with Canadian Business and covers a wide variety of subjects including corporate governance, the media and marketing. Prior to joining the magazine in April 2000, John lived and worked in New York covering the US financial markets for Knight Ridder Financial News

It should have been a glorious moment for Jim Balsillie. But as the co-CEO of Research in Motion was being named Outstanding Business Leader of the Year by Wilfrid Laurier University, the Ontario Securities Commission was reportedly demanding Balsillie and a handful of other company executives pay a $100-million fine to settle allegations they gave themselves millions of dollars in backdated stock options. But if Balsillie was worried about paying that record-breaking fine he didn’t show it. The people attending the gala lunch to fete the executive didn’t seem that concerned either. During a question and answer session not a single person asked about the potential whopping penalty.

Research in Motion shareholders don’t seem that concerned either — shares in the company barely moved after reports of the massive fine emerged. But that’s no surprise. They barely moved when the option backdating allegations first surfaced, and they didn’t move when RIM released the results of an internal investigation that acknowledged the company had engaged in backdating and announced a $250 million financial restatement. And why should they? Stock option backdating may actually be good for shareholders, argues a recent study conducted by graduate finance students from the Rotman School of Management and the Saunders School of Business.

These findings seem to defy logic about stock option backdating. After all...
options are supposed to align the interests of management with shareholders. The options are granted with an exercise price that is equivalent to the price of common stock on the day the options are granted. As the value of the common stock rises, so does the value of the stock options, which allows executives to reap the same benefit as shareholders. But when options are backdated, executives pick a date in the past when the value of company shares had dipped and pretend they granted the options on that date. The manoeuvre allows executives to lock in an instant profit, and shareholders, regulators and the taxman are none the wiser.

But it wasn’t an attempt to defraud shareholders that drove CEOs to engage in backdating, but rather an attempt to "lower compensation cost for a given level of managerial incentive," say Rotman’s Hamed Mahmudi and Saunders finance student Huasheng Gao, who together co-authored the paper Backdating Executive Stock Option Grants: An Agency Problem or Just Efficient Contracting?

Backdating options allows companies to offer lower cash compensation for the CEOs and enhance the incentives for managers, the paper suggests. “Backdating is negatively related with the CEO’s total annual compensation and his cash compensation,” the paper argues. “This evidence suggests that shareholders simultaneously grant less cash payment to CEOs when allowing them to backdate their option grants. What is more important, the total compensation cost is actually reduced in the presence of option backdating, which is contradictory to the view that backdating makes shareholders overpay.”

But there’s a problem with this argument: stock exchanges, securities regulators, tax authorities and even most company stock option plans don’t allow managers to backdate options. Backdating is a clear violation of how RIM said it grants stock options and that policy is written in plain English and included in the company’s annual management proxy circular. Are RIM’s managers, accountants, lawyers and directors so incompetent that they all misunderstood the most basic mechanics of the company’s stock option policy? That’s hard to believe. If it wasn’t corporate bungling, we are left to wonder if company managers knew what they were doing was wrong but opted to deceive shareholders, directors and regulators and knowingly submitted corporate filings and tax returns they knew were false. Neither option is very appetizing for shareholders.

RIM maintains it was incompetence that resulted in the backdating fiasco at the company. An internal investigation conducted by a special committee of RIM’s board found there was no “intentional misconduct on the part of any director, officer or employee responsible for the administration of the company’s stock option grant program.” The RIM board of directors has undergone a substantial makeover in the wake of the backdating scandal. Balsillie stepped down as RIM’s chairman, but remained co-CEO and a director on the board. Two long-serving directors also agreed to resign and were replaced by Barbara Stymiest, Royal Bank of Canada’s chief operating officer, and John Wetmore, IBM Canada’s CEO.

So what to make of the rumoured $100 million the OSC is seeking to extract from RIM’s executives? At first blush it seems pretty excessive. But while it may be the highest penalty the OSC has ever levelled, Balsillie and his co-CEO Mike Lazaridis can easily afford it. Even after the worst of the recent stock market meltdown, the two men are worth about $2.5 billion each. The RIM penalty is less than the record $468 million the U.S. Securities and Exchange Commission sought from William McGuire, the former CEO of United Health Group, for his role in backdating more than $1

While the U.S. SEC has charged dozens of companies — including high profile tech players such as Apple Corp., Pixar Studios and Monster.com — the only company to become the subject of a public OSC examination in the backdating debacle is RIM. But RIM executives are not the only ones to have profited from backdated stock options. At least 35 other Canadian companies engaged in the practice, according to a study commissioned by Siskind Cromarty Ivey & Dowler, the Toronto law firm that successfully sued RIM over its backdating practices. FirstService Corp. has already acknowledged it engaged in options backdating and Gammon Gold Inc. is currently fighting a lawsuit alleging executives at the company backdated their own options. Gammon denies engaging in any improper stock options grants.

Massive $100-million fines may make for good headlines, but it’s still an open question whether they will be effective in discouraging company executives from engaging in this — or any other dishonest practice. It is easy to make an example of RIM, but it would be a lot more effective if the OSC were to aggressively pursue other companies that may have engaged in this activity. Rather than fine one company $100 million, I would rather see 30 companies fined $3 million each and be forced to explain to shareholders how this happened and what they are doing to ensure it never happens again. That would go a lot further to restoring the trust and confidence that the stock market so desperately needs right now.