

Silicon Valley's Strange Affair with Stock Options

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Backdating: a Titanic disaster

- The biggest corporate scandal in U.S. history
- 270 U.S. companies under internal or federal investigations
- No place hit harder than Silicon Valley
- Dozens of executives fired, demoted, charged or convicted
- Huge restatements



A Titanic disaster (cont.)

- Delinquent securities filings, threats of delisting
- Scores of lawsuits
- Seeds of distrust among investors
- Execs, workers face tax nightmare
- Lawmakers call for reforms



Questions raised for Silicon Valley

- Is there a culture of cheating?
- Will investors lose trust in tech companies?
- How many companies will be crippled?
- Will companies give up on stock options?
- Will it hurt the valley's image?



Big questions

- Are stock options worth the trouble?
- Are they doomed to be scandalous?
- Can we make everyone – or anyone -- happy?



Your challenge as stock plan pros

“There are so many different strands to it. You can’t just talk about the contract piece of it without talking about the securities law piece of it without talking about the tax piece of it without talking about the labor piece of it.

“If anything, it has focused people on how complicated compensation is. For years people thought, ‘Oh, just get stock options. It’s easy money, anybody can do it. You don’t need a lawyer to help you with it. ‘Essentially, what people have realized is, ‘Hey, this is tricky stuff, and it requires people who know a lot to do it right.’ ”

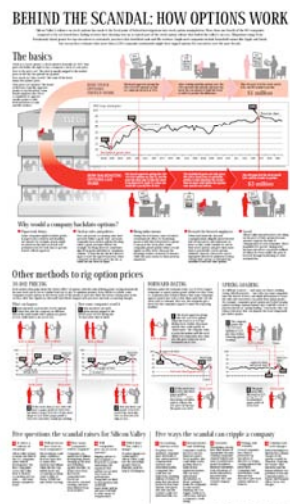
- *–Attorney Alisa Baker*

My evolution with stock options

- The first FASB fight: Pocket Protectors vs. Green Eyeshades
- Tax strategies
- The tech boom
- The tech bust
- The dark side of options
- FASB: The rematch
- The backdating scandal (or is it a witch hunt?)

What is backdating?

- Backdating
- Springloading
- 30-day pricing
- Forward dating
- Bullet-dodging



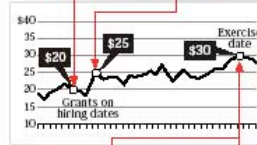
Other methods to rig option prices

30-DAY PRICING

Tech workers often gripe about the "lottery effect" of options, with the value of hiring grants varying dramatically because stock prices are so volatile from day to day. To minimize jealousy from cubicle to cubicle, some companies issued options at the lowest price of the month or gave new hires the lowest closing price in the 30 days after they signed on. Microsoft and Micrel stopped such practices and took accounting charges.

What can happen

1 Bob and Betty each receive 10,000 options when they join the company on different days in the same month. Bob's options are priced at \$20, while Betty's are set at \$25.



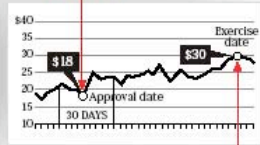
\$100,000



2 If the stock rises to \$30, Bob will have a paper profit of \$100,000, but Betty's is just \$50,000. If the stock drops to \$24, Bob's paper profit is \$40,000, but Betty would get nothing.

How some companies avoid it

1 Bob and Betty are both given options pegged to the lowest price of \$18 during the 30 days after they're hired.



\$120,000 each

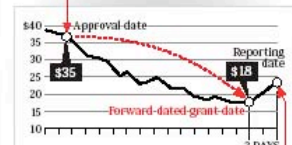


2 Bob and Betty can pocket \$120,000 each if the stock hits \$30 or \$60,000 if it slips to \$24.

FORWARD-DATING

Reforms under the Sarbanes-Oxley Act of 2002 require companies to report option grants within two days. Even so, academics have found evidence that some companies approve grants but wait to date them until they see the stock start to rebound. That way, the recipients get a boost but the companies appear to meet the reporting deadline.

1 The board approves giving the CEO 100,000 options when the stock is at \$35 but sliding lower. Rather than issue options that could quickly be "under water," the company waits to price the options until the stock climbs two consecutive days, then sets the price when the stock bottomed out at \$18.



2 If the stock rises to \$25, the CEO's paper profit is \$700,000 — rather than being worthless until it eclipses the \$35 price on the day the grant was OK'd.

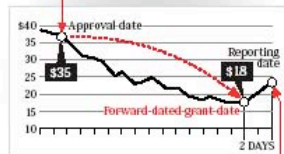
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20,000 each



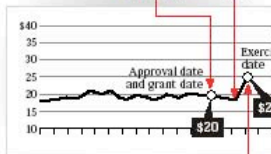
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SPRING-LOADING

It's difficult to prove — and some say there's nothing wrong with the practice — but critics say some companies time the release of news and inside information to boost the odds that executives can profit from option grants. For example, companies grant options just before issuing upbeat earnings announcements that could lift a stock, a practice known as "spring-loading." Conversely, they can release bad news that can depress the stock temporarily just before grants.

1 The company grants the CEO 100,000 options at \$20, just days before releasing upbeat earnings.



\$500,000



2 The good news lifts the stock to \$25, giving the CEO an immediate paper profit of \$500,000.

Why did backdating happen?

- Paperwork delays, expediency
- Unclear rules and policies
- Hiring inducements and rewards for favored employees
- A motivation to treat workers fairly, equitably
- Who was Typhoid Mary? Misguided advice from lawyers and auditors, plus word of mouth passed among peers

Why did backdating happen? (cont.)

- Small, inexperienced HR departments
- Poor records, inadequate software vulnerable to tampering Fear of the imperial CEO
- SEC rules left the window of opportunity wide open
- Silicon Valley's historical disdain for rules
- A sense that backdating was inconsequential
- Greed

People looked the other way...or worse

- Mercury Interactive's "magic backdating ink"
- KLA-Tencor's "time machine"
- Broadcom's not-so-old spreadsheet
- Monster's legal warning about pesky auditors



Who benefited?

- Executives
- Rank-and-file workers
- Companies
- Auditors, lawyers and the rest of the food chain



Then came “The Perfect Payday”

- A Pulitzer Prize for the Wall Street Journal (March 2006)



What is the aftermath of backdating?

- Crippled companies
- Firings and resignations
- Civil and criminal charges
- SEC settlements
- Delinquent filings
- The risk of delisting
- Financial restatements
- (But that’s not all...)



The aftermath (cont.)

- Bond payments triggered
- Tortured disclosures, convoluted conclusions
- New policies, tighter oversight, clearer administration
- Tighter auditing practices
- Scores of lawsuits (the introduction of the Stock Options Litigation Reporter)



Even more aftermath

- Trading blackouts
- Tax maneuvers to spare optionees
- Investor backlash (but prices don't necessarily suffer)
- Corporate governance reforms
- Another reason to dump options



Questions?

Thank you for your participation

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