**Testimony of Christopher Cox**
**Chairman**
**U.S. Securities and Exchange Commission**
**"Options Backdating"**

**Before the Committee on Banking, Housing, and Urban Affairs**
**United States Senate**

**September 6, 2006**

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee:

Thank you for inviting me to testify today about options backdating. This issue is one of intense public interest because it strikes at the heart of the relationship among a public company's management, its directors, and its shareholders. I appreciate the opportunity to explain the Commission's initiatives to deal with abuses involving the backdating of options.

I am especially pleased to testify together with Chairman Mark Olson of the Public Company Accounting Oversight Board. I will let Chairman Olson speak to the steps the PCAOB is taking to address these issues from the auditing regulator's perspective, but I'd like to assure the Committee, and the public, that the Commission is working in close cooperation with the PCAOB in this important area.

There are many variations on the backdating theme. But here is a typical example of what some companies did: They granted an "in-the-money" option—that is, an option with an exercise price lower than that day's market price. They did this by misrepresenting the date of the option grant, to make it appear that the grant was made on an earlier date when the market value was lower. That, of course, is what is meant by abusive "backdating" in today's parlance.

The purpose of disguising an in-the-money option through backdating is to allow the person who gets the option grant to realize larger potential gains—without the company having to show it as compensation on the financial statements.

Rather obviously, this fact pattern results in a violation of the SEC's disclosure rules, a violation of accounting rules, and also a violation of the tax laws.

The SEC has been after the problem of abusive options backdating for several years. As a preliminary step in explaining the Commission's response to the problem of fraudulent options backdating, it would be useful to put the whole topic of options compensation into some perspective.

As you know, during the last year the Commission has been intensely focused on the quality of disclosure of executive compensation. Very recently, we enacted new rules that will require, beginning with the next proxy season, the full disclosure of all aspects of executive and director pay and benefits. A key component of that disclosure will be

compensation in the form of stock options, which has been a fast growing portion of executive pay since the early 1990s.

Under the new SEC rules, all of an executive's compensation will now be totaled into one number, so that it can be compared easily from person to person, company to company, and industry to industry. The new rules also require detailed disclosure of compensation in the form of stock options, which will show whether a company has backdated options, and if so, why. The purpose of the new executive compensation rules is to make the CEO's pay understandable to the shareholders who own the company.

Of course, no new SEC rules would be necessary to make executive pay transparent, if executives were all paid in the form of salary. But beyond the obvious fact that the income tax code discriminates in favor of non-salary compensation that can be taxed as capital gains, one of the most significant reasons that non-salary forms of compensation have ballooned since the early 1990s is the $1 million legislative cap on salaries for certain top public company executives that was added to the Internal Revenue Code in 1993.

As a Member of Congress at the time, I well remember that the stated purpose was to control the rate of growth in CEO pay. With complete hindsight, we can now all agree that this purpose was not achieved. Indeed, this tax law change deserves pride of place in the Museum of Unintended Consequences.

There are other accounting and tax reasons, as well, that stock options over the years were increasingly included in the compensation packages of executives and non-executives.

Beginning in 1972, the accounting rule was that employee stock options wouldn't have to be shown as an expense on the income statement—so long as the terms were fixed when the option was granted, and so long as the exercise price was equal to the market price on that day. Indeed, no expense would ever need to be recorded in the financial statements for fixed options that weren't granted in-the-money.

In addition to this favorable accounting treatment, there was a tax benefit. The million-dollar cap on the tax deductibility of executive compensation, which I mentioned earlier, doesn't apply to options granted at fair market value. So for companies that wanted or needed to pay compensation in excess of $1 million per year, the tax code outlawed deducting it if it was paid in a straightforward way through salary, but permitted a deduction if the compensation was paid through at-the-money options.

And of course there were other reasons, many of them good ones with solid economic rationales, that companies wanted to use options as a form of compensation. For example, a properly-structured option plan can be useful in more closely aligning the incentives of shareholders and managers. And for growth companies, the use of stock options as compensation offers a way to conserve resources while attracting top-flight talent in highly competitive markets.

All of these factors have contributed to the now-widespread use of stock options as compensation. But just as option compensation increased, so did the potential for abuse. And Congress deserves credit for taking preemptive action that we now know was critical to stopping the spread of the backdating contagion.

Four years ago, in 2002, the Sarbanes-Oxley Act very presciently tightened up on the reporting of stock option grants. Before Sarbanes-Oxley, officers and directors didn’t have to disclose their receipt of stock option grants until after the end of the fiscal year in which the transaction took place. So a grant in January might not have to be disclosed until more than a year later. SOX changed that, by requiring real-time disclosure of option grants. And in August 2002, shortly after the law was signed, the SEC issued rules requiring that officers and directors disclose any option grants within two business days.

Not only must option grants now be reported within two business days, but this information was among the first required to be filed electronically using interactive data. Thanks to this new data-tagging technology, the public now has almost instant access to information about stock option grants.

The following year, in 2003, the SEC took another important step that has helped increase the transparency of public company options plans. The Commission approved changes to the listing standards of the New York Stock Exchange and the Nasdaq Stock Market that for the first time required shareholder approval of almost all equity compensation plans. Companies have to publicly disclose the material terms of their stock option plans in order to obtain shareholder approval.

Very importantly, the required disclosures include the terms on which options will be granted. And companies must tell their shareholders whether the plan permits options to be granted with an exercise price that’s less than the market value on the date of grant.

Then, in December 2004, the FASB issued Statement of Financial Accounting Standard 123R, which effectively eliminated the accounting advantage that had previously been given to stock options issued at-the-money. Since this new accounting rule took effect, all stock options granted to employees have to be recorded as an expense in the financial statements, whether or not the exercise price is at fair market value. This rule is nearly fully phased in.

Most recently, in January of this year, the SEC proposed that public companies be required to more thoroughly disclose their awards of in-the-money options to certain executives. The Commission also proposed that companies be required to disclose the fair value of the option on the grant date, as determined under the new accounting rules. The Commission adopted final rules on these subjects on July 26, 2006. As a result, in the next proxy season beginning in the spring, all public companies will now report this information in clear, easy to understand tabular presentations.

The tables will include:

- The grant date fair value under FAS 123R (which is aggregated in the total compensation amount that is shown for each named executive officer);

- The FAS 123R grant date;

- The closing market price on the grant date if it is greater than the exercise price of the option; and

- The date the compensation committee or full board of directors took action to grant the option, if that date is different than the grant date.

Because the dates and numbers often don't tell the whole story, companies will also be required to discuss the policies and goals of their compensation programs—in plain English. The reports to investors will describe whether, and if so how, a company has engaged (or might engage in the future) in backdating or any of the many variations on that theme concerning the timing and pricing of options. For example, if a company has a plan to issue option grants in coordination with the release of material non-public information, that will now be clearly described.

The Commission will continue to avail itself of every opportunity to clarify the rules and procedures for options issuance going forward. To that end, you can expect that the Office of the Chief Accountant will soon issue further public guidance on the accounting issues surrounding backdating.

So, to recap, here is what has been done by way of prophylactic rules to eliminate the opportunities for abusive backdating. First, Sarbanes-Oxley has closed the disclosure loophole that permitted months and sometimes more than a year to elapse before option grants had to be reported. Second, a new accounting rule—FAS 123R—has eliminated the accounting benefit of granting at-the-money options. And third, the SEC's brand new executive compensation rules now require a complete quantitative and narrative disclosure of a company's executive compensation plans and goals. That enhanced disclosure will make it clear whenever options are being backdated, and it will require an explanation of the reasons. These new rules will soon be complemented by additional accounting guidance on these subjects.

Each of these steps by itself is an important contribution to preventing backdating abuse. In combination, they have effectively slammed the door shut on the easy opportunities to get away with secretive options grants. That's why almost all of the stock option abuses our Enforcement Division has uncovered started in periods prior to these reforms.

But while these accounting and disclosure rules changes have made it easier to detect and punish backdating abuses going forward, uncovering the problems from prior years has been quite a challenge.

A few years ago, the SEC began working with academics to decipher market data that provided the first clues something fishy was going on. One of the academics with whom the SEC worked was Erik Lie of the University of Iowa, who subsequently published a paper in 2005 that showed compelling circumstantial evidence of backdating.

Dr. Lie's data showed that before 2003, a surprising number of companies seemed to have had an uncanny ability to choose grant dates that coincided with low stock prices. (In a follow-up paper this year, co-authored with Dr. Randall Heron of Indiana University, Dr. Lie demonstrated that this problem has greatly diminished since 2002, when the Sarbanes-Oxley Act shortened the time for reporting option grants to two business days.)

With a fair amount of detective work, and with the aid of economic research conducted by the SEC's Office of Economic Analysis, the Commission succeeded in turning what had begun as mere evidentiary threads into solid leads. Eventually, some of the evidence we began turning up was so compelling that several U.S. Attorneys took a criminal interest. Over the past several years, our inventory of backdating and related investigations has grown substantially. And beginning three years ago, the SEC has brought several enforcement actions against companies and individuals for fraudulent option practices.

For example, in 2003, the Commission charged Peregrine Systems, Inc. with financial fraud for failing to record any expense for compensation when it issued incentive stock options. The SEC's complaint alleged that at each quarterly board meeting, the company's directors would approve a total number of options for employees. The company would then allocate the options to the employees during the quarter. But the options wouldn't be priced until the day after the next quarterly Board meeting. On that day, the company looked back at the market price of its stock between the two quarterly Board meetings, and picked the lowest price. That turned the options into in-the-money grants. But even though accounting rules required that they then be recorded as compensation expense, the company didn't do that. As a result, Peregrine understated its expenses by approximately $90 million.

The following year, in 2004, the SEC brought a case involving the manipulation not of option grants, but of exercise dates. Our complaint charged that Symbol Technologies, Inc. and its former general counsel fudged option exercise dates so that senior executives could profit unfairly at the company's expense. Rather than use the actual exercise date as defined by the company's option plans, the general counsel picked the most advantageous date from a 30-day "look-back" period in order to come up with a lower exercise price. This was done without board approval or public disclosure. The SEC charged that to create the false appearance that these exercises had actually occurred on the chosen dates, the company's general counsel had instructed his staff to backdate the relevant documents, and to substitute phony exercise dates on the forms the executives used to report their option exercises to the SEC and the public. The result, according to the complaint, was a serious misstatement of the company's stock option expenses.

When the company subsequently restated its improper accounting, the cumulative net increase in reported stock option expenses was $229 million. The amount would undoubtedly have been higher had it not been for the passage of the Sarbanes-Oxley Act. Thanks to the Act's new two-day deadline for reporting options transactions by officers and its prohibition on company loans to officers and directors, the company and its general counsel had put a halt to the "look-backs" because the law had rendered the practice unfeasible.

While the alleged manipulations of option grants and exercises in these two cases were part of larger accounting fraud charges, two more recent cases have focused solely on option practices. These are the Brocade and Comverse actions that the SEC filed in July and August of this year. The executives charged in these cases are contesting the SEC's allegations.

In July, the SEC filed a civil fraud action against three former executives of Brocade Communications Systems, alleging that the former CEO and the former Vice President of Human Resources routinely backdated stock option grants to give employees favorably priced options without recording the necessary compensation expenses. Specifically, the SEC's complaint alleges that the CEO caused Brocade to grant in-the-money options to both new and current employees between 2000 and 2004, and then backdated documents to make it appear that the options were at-the-money when granted. This had the effect of concealing millions of dollars in expenses from investors.

The complaint alleges that the CEO repeatedly used hindsight to select a date with a lower stock price from the recent past as the purported option grant date, and that, to facilitate the scheme, the Human Resources executive created, or directed others to create, false paperwork making it appear that the options had been granted on the earlier date. The complaint alleged that, in some instances, employment offer letters and compensation committee minutes were falsified to suggest that options had been granted to employees before they had even been hired by the company.

The SEC's complaint also charged Brocade's former CFO, alleging that he learned of the backdating after joining the company but took no action to correct or halt the practice and instead signed Brocade's SEC filings. When these stock option practices surfaced, Brocade was required to restate and revise its financial statements for six fiscal years, from 1999 through 2004. The scheme resulted in the inflation of Brocade's net income by as much as $1 billion in the year 2000 alone. Simultaneously with the filing of the SEC's complaint, the U.S. Attorney's Office for the Northern District of California separately filed criminal charges against the former CEO and the former Vice President of Human Resources for the same misconduct.

In the second recent case, the Commission filed a civil fraud complaint last month against three former senior executives of Comverse Technology, Inc., alleging that they engaged in a decade-long fraudulent scheme to grant undisclosed, in-the-money options to themselves and to others by backdating stock option grants to coincide with historically low closing prices of Comverse common stock.

The complaint alleges that from 1991 to 2002, Comverse's founder and former Chairman and CEO repeatedly used hindsight to select a date when the closing price of Comverse's common stock was at or near a quarterly or annual low. According to the complaint, the CEO then communicated this date and closing price to Comverse's former general counsel who, with the CEO's knowledge, created company records that falsely indicated that a committee of Comverse's board of directors had actually approved the option grant on the date the CEO had picked.

The complaint also alleges that Comverse's former CFO joined the scheme no later than 1998, and assisted in selecting backdated grant dates. It is alleged that each of the three defendants realized actual illicit gains from the backdating when they sold stock they acquired from exercises of backdated options, including at least $6 million by the CEO alone. In addition, the complaint alleges that the former CEO and CFO created a slush fund of backdated options between 1999 and 2002 by causing options to be granted to fictitious employees and, later, used these options to recruit and retain key personnel.

Comverse has publicly announced that it expects to restate historical financial results for multiple years in order to record material charges for option-related compensation expenses. Simultaneously with the filing of the SEC's complaint, the U.S Attorney's Office for the Eastern District of New York unsealed a criminal complaint charging these three executives with conspiracy to violate the antifraud provisions of the federal securities laws, wire fraud, and mail fraud by engaging in the same scheme.

These cases demonstrate some of the variations on the basic theme of fraudulent backdating that the Commission has uncovered. They involve backdated option grants that are more profitable to recipients; backdated option exercises that reduce recipients' taxes at the expense of shareholders; options granted to top executives; and options granted to rank and file employees. They involve actual personal gain to wrongdoers, and real harm to companies that failed to properly account for the options practices.

Unfortunately, these cases that I've used as illustrations are not the only matters the SEC has under investigation. The SEC's Division of Enforcement is currently investigating over 100 companies concerning possible fraudulent reporting of stock option grants. The companies are located throughout the country, and include Fortune 500 companies as well as smaller cap issuers. They span multiple industry sectors.

You should not expect that all of these investigations will result in enforcement proceedings. At the same time, we have to expect other enforcement actions will be forthcoming in the future.

The SEC's Enforcement staff is sharing information related to its investigations with other law enforcement and regulatory authorities as warranted and appropriate, including the Department of Justice, the President's Corporate Fraud Task Force, U.S. Attorney's offices around the country, the Federal Bureau of Investigation, and the Internal Revenue Service.

In our rulemaking, our provision of accounting and final regulatory guidance, and our enforcement programs, the SEC has been and will remain vigilant in the battle against fraudulent options backdating. The agency is grateful for the opportunity to provide you with this update on a very important subject. I am happy to take any questions you may have.