Department of Justice

STATEMENT

OF

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UNITED STATES DEPARTMENT OF JUSTICE

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

CONCERNING

"EXECUTIVE COMPENSATION:
BACKDATING TO THE FUTURE, OVERSIGHT OF CURRENT ISSUES
REGARDING EXECUTIVE COMPENSATION
INCLUDING BACKDATING OF STOCK OPTIONS; TAX TREATMENT OF
EXECUTIVE COMPENSATION, RETIREMENT AND BENEFITS"

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Testimony of

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"Executive Compensation: Backdating to the Future, Oversight of Current Issues Regarding Executive Compensation including Backdating of Stock Options; Tax Treatment of Executive Compensation, Retirement and Benefits."

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Chairman Grassley and Members of the Committee, thank you for the opportunity to be here today to discuss the practice of backdating stock option grants to executives at publicly-held corporations. As you know, this practice received wide-spread publicity when it was initially uncovered, and it is now being investigated by civil regulators and by the Department of Justice.

Let me begin my testimony with a brief description of the mechanics of this practice and then discuss how it can violate the criminal statutes. Options are contractual rights to purchase a share of stock on a future date at a set price (known as the "strike" price"), and they are often granted to corporate employees as part of their compensation package. Under most plans, the employees cannot exercise the options until a vesting period has passed. Typically, the strike price is the market or trading price of the stock on the day the option was granted by the corporation's board of directors, commonly acting through its compensation committee. The employee can buy the stock at the end of the vesting period at the strike price and realize a profit by selling it when it is trading at a higher price than the strike price. Thus, options are often granted to give employees incentives to work hard – their hard work will theoretically result in more profit for the company and a corresponding increase in the market price of the stock.

Of most concern in the practice of backdating options is that when certain options are granted the options are already "in the money" or show a profit to the option-holder. It might be beneficial to define some of these terms so that in discussing this issue, we are all using a common vocabulary. Let me differentiate between "at the money" and "in the money." Options with a strike price equal to the current trading price of the underlying stock are referred to as being "at the money" and options with a strike price below the current trading price of the stock are "in the money." The practice we are investigating involves stock options that are backdated so that they are "in the money" at the time of the grant. Options that are "in the money" give the option-holder a paper profit, since they have a value based on the difference between the strike price and the current higher trading price, even though the employee has not exercised the option and sold the stock. When options are backdated in this way, the strike price is fixed on a certain date when that day's market price for the stock was lower, but in actual fact, the options were granted at a later date when the share price of the stock was higher. The practice of backdating allows corporate wrongdoers to fix a lower strike price for the options, locking in an immediate gain to the option holder.

Significant accounting, disclosure and tax consequences resulting from grants of "in the money" options provide an incentive for corporate executives to covertly backdate these options. As a result, some corporate executives have engaged in schemes to falsify corporate books and records, to mislead the corporation's board of directors and outside auditors, to file false reports and financial statements with the Securities and Exchange Commission (SEC), and to mislead shareholders, the investing public and the financial press.

How can stock option backdating become a crime? There are several possibilities. First, a grant of "in the money" options is treated under accounting principles as compensation to the option holder, and therefore should be treated as an expense by the corporation and be deducted from reported revenue. In contrast, grants of options with an exercise price either above or at the trading price on the real grant date are not considered an expense of the corporation. Thus, if a corporation both backdates options and prices them "in the money" without properly disclosing this fact, the corporation is falsifying its books and records, fraudulently decreasing expenses and falsely inflating profits. Second, backdating of stock options also conceals the fact that employees are being given the right to purchase the underlying stock at a discount from the fair market value on the date the option was really granted – and that misrepresents the employee's compensation. Finally, the sale of the underlying stock to these favored employees at a discount to the market price dilutes the value of the shares held by stockholders.

Corporations are required to accurately report compensation and other remuneration to officers, including the nature of the compensation. Corporations are also required to accurately describe the stock option plans for which they request shareholder approval. When stock options are surreptitiously backdated, the corporation will file false and misleading reports and financial statements with the SEC and other regulatory authorities. By doing that, the corporation disseminates false and fraudulent information to the investing public. Failing to report the backdating of options misrepresents the true nature of stock option plans and executive compensation and thus, a company obtains shareholder approval for the company's compensation plans under false pretenses. Grants of backdated options contrary to the terms of shareholder-approved option compensation plans can also be considered an embezzlement of corporate assets because the defendants are misappropriating shares of the company at an unauthorized and discounted value.

Secretly backdating options to a date with a lower market price may also have tax consequences for the employee and the corporation. If the stock option is a qualifying Incentive Stock Option, the employee can, under certain circumstances, defer tax for many years and pay tax at lower capital gains rates. However, to qualify as an Incentive Stock Option, the option price must not be "in the money" or less than the fair market value at the time of the grant; otherwise, the employee must pay ordinary income tax rates when the option is exercised. Also, corporations may not qualify under the Internal Revenue Code for certain deductions for stock issued under "in the money" options to highly paid executives. Consequently, backdating options may lead to the filing of false tax returns by the corporation and the employee if the true nature of the option is misrepresented.

When this practice was first disclosed, the Department of Justice moved quickly to determine whether it warranted criminal investigation. Many companies had restated their earnings and made public filings to that effect. At the same time, the United States Attorneys' Offices throughout the country, assisted by agents of the Federal Bureau of Investigation, initiated contact with the SEC and began to investigate. In Silicon Valley, where much of this backdating occurred, an organized team approach to assess the criminal implications of backdating was needed. On July 13, 2006, the United States Attorney for the Northern District of California announced the formation of a stock options backdating task force to investigate allegations that corporations and individuals in Northern California had "retroactively changed the grant dates of stock options with the intent to defraud." The Task Force, consisting of personnel from the United States Attorney's Office and the FBI, is investigating companies in the Northern District of California to determine whether any of these companies or individuals engaged in fraudulent option backdating or related criminal conduct.

To date, there have been two criminal cases filed alleging that backdating of options constituted violations of the federal securities laws and other criminal statutes. In *United States v. Reyes*, *et al.*, an eight count indictment was filed in the United States District Court for the Northern District of California, charging the former CEO, President and Chairman, and the former Vice President of Human Resources of Brocade Communications Systems, Inc., with conspiracy, securities and mail fraud and falsifying books and records. The allegations involve a scheme from 2000 to 2004 to defraud Brocade, the Board of Directors, its shareholders and auditors, the public and the SEC when the defendants caused the corporation to grant "in the money" options to both new and current employees by backdating documents to make it appear the options were issued at fair market value -- concealing millions of dollars in expenses from investors. The defendants allegedly created false documents such as employment offer letters and compensation committee minutes which purported to document that options were granted to employees earlier and at a lower price than they actually were granted. The government alleges these activities resulted in the creation of false and misleading financial statements, audited reports and other documents and false filings with the SEC.

In *United States v. Jacob Alexander, et al,* in a Criminal Complaint filed in the Eastern District of New York, the former CEO, CFO and General Counsel of Comverse Technology, Inc., are charged with conspiracy to commit securities fraud, wire fraud and mail fraud for a fraudulent scheme between 1998 and 2002 to grant secretly backdated "in the money" options to themselves and others. It is alleged that they backdated stock option grants to coincide with low closing prices of the underlying stock. According to the Complaint, two of the defendants also created a "slush fund" by causing backdated options to be issued to fictitious employees and later used these options to recruit and retain key employees. Finally, it is alleged that they made material misrepresentations to Comverse investors, issued false proxy statements, and filed false reports and financial statements that concealed and misrepresented the results of operations and expenses of Comverse.

The cases I have just described have only recently been indicted and the defendants are presumed innocent of these allegations, unless and until proven guilty in a court of law.

Backdating cases that are viewed as appropriate for criminal resolution are being prosecuted on the theory that the defendants violated the federal securities statutes and other anti-fraud statutes by (1) falsifying corporate books and records to conceal the fact that option grants were backdated; (2) causing the preparation of false and misleading financial statements and other documents; (3) lying to the corporation's board of directors, and auditors and the SEC; and (4) misleading investors and the financial press and filing false reports with the SEC. In other words, our theories of prosecution are concerned with the accuracy and adequacy of disclosure of material information and, in that respect, they are similar to many other DOJ prosecutions for corporate fraud. Our corporate fraud indictments typically allege falsification of books and records, concealment of material information, causing false and misleading information to be disseminated to the investing public and financial analysts, and filing false reports and documents with the SEC.

In discussion of this issue, defense counsel and corporate officials have argued that granting “in the money” options is not *per se* illegal and may serve a legitimate corporate purpose in attracting and retaining the most competent employees in the industry. Let me emphasize this -- we do not attack the legitimacy of granting “in the money” options if the practice is fully disclosed and shareholder approval is obtained where necessary. Our cases concern falsification of corporate records, concealment and misrepresentation in the way in which the options were granted and priced, and deceptive conduct that may mislead the corporation, its directors, auditors, shareholders, and the investing public. Indeed, in the *Alexander* case the defendants are alleged to have falsely promised institutional investors that the company would not grant “in the money” options at the very same time the defendants were causing the company to grant such options by secretly backdating them.

In addition to the charges I previously mentioned, fraudulent conduct involving backdated options can be investigated and prosecuted under other criminal statutes enacted as part of the Sarbanes-Oxley legislation, such as securities fraud, 18 U.S.C. § 1348; knowingly certifying false statements filed with the SEC, 18 U.S.C.§ 1350; destroying, falsifying or altering records in federal investigations, 18 U.S.C. § 1519; and destroying corporate audit records, 18 U.S.C. § 1520. Of course, some of this conduct may predate Sarbanes-Oxley, and in those instances, that legislation cannot be used. These cases may also be amenable to prosecution under criminal statutes relating to obstruction of justice, perjury, and criminal tax violations. Thus, the Department can rely on a number of statutes in charging this conduct. To the extent that the Committee is considering taking action to prevent this practice, the Department has a range of statutory options and it is not requesting any new legislation to deal with this specific problem.

The practice of stock option backdating to conceal information from corporate boards and regulatory authorities can only be seen as a brazen abuse of corporate power to artificially inflate the salaries of corporate wrongdoers at the expense of shareholders. By fraudulently backdating grants, defendants evade significant accounting, disclosure and tax requirements that flow from granting “in the money” options. Properly accounting for these grants would have reduced reported corporate earnings, created tax liability for option recipients and the company, and obligated the company to inform shareholders that it was offering stock at a discounted price. For some of those companies that have now disclosed backdated grants, corporate reputations have been tarnished and shareholder value has diminished substantially.

Like other forms of corporate fraud, the Department of Justice takes stock option backdating seriously, and we will continue to use our best efforts to uncover criminal conduct where it occurs. While we cannot say at this juncture how many cases we will ultimately investigate or what number will be more appropriately resolved as criminal, rather than as civil matters, we are committed to using the resources of our experienced securities fraud prosecutors and investigative agencies throughout the country to ensure that each matter we open is thoroughly investigated. Moreover, as Chairman of the Corporate Fraud Task Force, I made this issue a top priority during our July 27, 2006, meeting, and there was a productive discussion about backdating with task-force member agencies. In addition to the SEC, the Internal Revenue Service is now reviewing this practice to determine the tax consequences for companies and executives. In short, federal law enforcement agencies are working together to prevent fraudulent stock option backdating practices and to promote transparency in corporate governance whenever we are able to do so. This is a duty we owe to the American people, whose hopes, dreams and futures are tied more and more to the integrity of our stock markets.

Thank you again for the opportunity to appear before you today, and I look forward to answering the Committee's questions.