

Backdating History: Assessing the SEC's Early Stock Option Dating Cases

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Without question, this past summer baked a hot new priority into the SEC's enforcement agenda: stock option dating practices. With more than 100 companies reportedly under investigation at last authoritative check,¹ most practitioners expect to see a wave of enforcement filings in the coming months. Indeed, the SEC and the Department of Justice have already filed both civil and criminal charges against several former executives of Brocade Communications Systems, Inc. and Comverse Technology, Inc. (For more on the current state of stock options backdating investigations, see the September issue of *Wall Street Lawyer*, vol. 10, no. 9.)

However, contrary to most reports and analyses, these cases were *not* the first to allege manipulation of dates in connection with stock options, nor did they unveil any controversial new legal theories. As discussed below, the Brocade and Comverse cases present just the latest twist on long-standing SEC disclosure theories regarding executive compensation.

Brocade and Comverse: The "First" Options-Backdating Cases

On July 20, the SEC, the United States Attorney's Office for the Northern District of California, and the FBI jointly announced the filing of civil and criminal options-backdating charges against two former executives Brocade.² The government alleged that the executives – the former chief executive officer and a former human resources executive – routinely backdated stock option grants in order to give Brocade employees more favorably priced options without recording necessary compensation expenses. The criminal complaint charged the executives with securities fraud in violation of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (the "Exchange Act"), which carries a potential sentence of 20 years in prison and \$5 million in fines.³ Both defendants have maintained their innocence.

The SEC's civil complaint, which also named Brocade's former chief financial officer as a defendant, charged all three executives with violating the same Exchange Act provisions, as well as with making fraudulent stock sales in violation of Section 17(a) of the Securities Act of 1933; falsifying company accounting records in violation of Exchange Act Section 13(b)(5) and Exchange Act Rule 13b2-1; misleading the company's accountants in violation of Exchange Act Rule 13b2-2; aiding and abetting the company's violations of its reporting, disclosure, record keeping, and internal controls

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obligations; and – as to the former chief executive officer and chief financial officer, who had each signed Sarbanes-Oxley certifications attesting to the accuracy of the company’s SEC filings – making false certifications in violation of Exchange Act Rule 13a-14. The SEC is seeking injunctions against future violations of these provisions, disgorgement of profits from stock sales, civil penalties of up to \$120,000 for each violation, and orders prohibiting the former chief executive officer and chief financial officer from future service as officers or directors of any public companies. All three defendants are contesting the SEC’s charges.

Three weeks after the government filed its charges in the Brocade case, it dropped the other shoe. On August 9, the SEC, DOJ, FBI, and United States Attorney for the Eastern District of New York jointly announced civil and criminal options-backdating charges against the former chief executive officer, the former chief financial officer, and the former general counsel of Comverse. According to the government’s charges, these executives engaged in a decade-long practice of using hindsight and fabricated corporate records to grant backdated, in-the-money stock options to themselves and others. The former chief executive officer and former chief financial officer were also accused of creating a “slush fund” of backdated options by secretly inserting fictitious names among the names of actual Comverse employees on option grant lists submitted to the company’s board of directors for approval, and then using the “slush fund” to recruit and retain key personnel. The criminal complaint charged all three defendants with conspiracy to commit securities, mail fraud, and wire fraud, which each carry a maximum sentence of five years imprisonment plus criminal fines. All three defendants are contesting the charges.

On Sept. 27, the FBI announced the arrest of Comverse’s former chief executive officer, Kobi Alexander, in the African country of Namibia. Alexander had been a fugitive for more than a month after missing a federal court appearance.

The SEC’s civil complaint alleged fraudulent stock sales in violation of Securities Act Section 17(a); securities fraud in violation of Exchange Act Section 10(b) and Rule 10b-5; false and misleading proxy disclosures in violation of Exchange Act Section 14(a) and Rule 14a-9; falsification of accounting records in violation of Exchange Act Section 13(b)(5) and Rule 13b2-1; false and

misleading statements to the company’s accountants in violation of Exchange Act Rule 13b2-2; false, misleading, and in some cases missed filings of beneficial ownership reports in violation of Exchange Act Section 16(a) and Rule 16a-3; aiding and abetting Comverse’s violations of its Exchange Act disclosure, record keeping, and internal controls obligations; and – as to the former chief executive officer and chief financial officer – false Sarbanes-Oxley certifications in violation of Exchange Act Rule 13a-14. Based on these alleged violations, which all defendants are contesting, the SEC is seeking injunctions against future violations, disgorgement of ill-gotten gains, monetary penalties, and orders barring all three defendants from future service as officers or directors of any public company.

The Brocade and Comverse cases offer companies and their counsel a good deal of insight into the government’s legal theories regarding how options backdating can violate the law. These cases nevertheless leave many questions unanswered because the charges remain unresolved and because the cases – quite conspicuously – included no charges or public resolution as to the companies themselves.

Earlier Cases and Tea Leaves

Despite the media fanfare surrounding the filing of the Brocade charges, that case was by no means the government’s first salvo in its campaign against options backdating. To the contrary, at least two earlier SEC settlements have included options-backdating allegations against the companies themselves, although those allegations were largely buried in the midst of more serious allegations in both cases. Moreover, in connection with an unrelated and apparently ongoing SEC investigation, another public company disclosed nearly a year ago – in considerable detail – the options-backdating charges the SEC staff was threatening to bring against it.

More than three years ago, in its “massive financial fraud” case against Peregrine Systems, Inc., the SEC included options-backdating allegations against the company that were so overshadowed by other misconduct that they were all but ignored at the time. Indeed, although the options-backdating allegations were comparable to those that made headlines throughout the summer of 2006, and although the conduct was blamed for a \$90 million

understatement of expenses by Peregrine, the SEC's complaint devoted only a few sentences to this aspect of the case:

Peregrine improperly failed to record a compensation expense when it issued incentive stock options. At each quarterly Board meeting, Peregrine's Board of Directors approved the total number of stock options that could be granted to employees before the next quarterly Board meeting. Peregrine then allocated the options to employees during the quarter, but did not price the options until the day after the next quarterly Board meeting. On that day, Peregrine's Stock Administrator looked back at the market price of Peregrine's stock between the two quarterly Board meetings, to find the lowest price at which Peregrine's stock had traded. That is where Peregrine set the stock option exercise price, to benefit those who received the stock options. Peregrine's then outside auditors knew that this was how Peregrine was pricing its options. Under the applicable accounting rules, any positive difference in the stock price between the exercise price and that on the measurement date (here, the date on which the Stock Administrator looked back) had to be accounted for as compensation expense. By failing to record the compensation expense, Peregrine understated its expenses by approximately \$90 million.⁴

Interestingly enough, the SEC's litigation release ignored this part of the case entirely,⁵ and no individuals appear to have been charged in connection with the options backdating. For its part, the company – by then in bankruptcy – ended up settling the case without paying any monetary penalty or disgorgement.⁶

The following year, the SEC again leveled options backdating charges in another of its major financial fraud cases, and those allegations were again largely ignored at the time. Specifically, the agency's June 2004 accounting fraud case against Symbol Technologies, Inc. included options-backdating charges against that company and its former general counsel.⁷ The backdating at Symbol allegedly involved the use of hindsight in selecting the reported *exercise* dates of options transactions rather than the reported grant dates, but the government's legal theories were essentially the same

as those asserted in today's cases. Symbol settled all of the charges against it when the case was filed, and the general counsel ultimately settled the case in February, shortly before the media firestorm that triggered the government's current wave of stock option investigations.⁸

The statutory violations in Symbol were similar to those later alleged in Brocade and nearly identical to those alleged in the Comverse case, inasmuch as they included misleading proxy disclosures in violation of Exchange Act Section 14(a) and Exchange Act Rules 14a-3 and 14a-9 (with the company charged as the primary violator and the general counsel held liable as a "control person") and, as to the general counsel, misleading beneficial ownership reports in violation of Exchange Act Section 16(a) and Exchange Act Rule 16a-3. As part of the settlement, and without admitting or denying the SEC's allegations, Symbol was enjoined and paid a \$37 million civil penalty (presumably based in large part on the overall accounting fraud rather than just the options-backdating part of the case), while the general counsel was enjoined, barred from serving as a director or officer of any public company, and suspended in a related SEC Rule 102(e) proceeding from appearing or practicing before the SEC as an attorney.⁹ In October 2004, the general counsel also pled guilty to criminal tax charges arising from his option backdating activities and agreed to pay \$2 million to resolve a related civil forfeiture proceeding.¹⁰

In addition to its case filings against Brocade, Comverse, Peregrine, and Symbol, the SEC has left several other clues regarding what companies and executives can expect in terms of charging decisions for options-backdating violations. One such clue arises from the SEC's ongoing investigation of Analog Devices, Inc., which apparently began at least as early as November 2004. On November 15, 2005, the company issued a press release detailing a tentative settlement it had reached with the SEC staff subject to formal approval by the Commission.¹¹

According to the press release, the settlement would include charges not only of options backdating but also of options postdating – i.e., selecting a grant date *subsequent* to the actual grant date, presumably to take advantage of an interim stock price decline – and of "spring loading" – i.e., issuing properly dated stock options either just before favorable company news or just after negative company news. The

release said the settlement would charge the company with backdating option grants by several days in both September 1998 and July 2001, with postdating an options grant by one day in November 1999, and with spring loading options grants in both November 1999 and November 2000. It further said that, under the proposed settlement, the SEC would issue a cease-and-desist order against the company (presumably in lieu of seeking an injunction in federal court as it did in the above discussed cases) that would charge violations of Exchange Act Section 10(b) and Rule 10b-5, the company would pay a \$3 million civil penalty (which, under current law, would require the SEC to file a parallel complaint in federal court), and the company would reprice certain options. Finally, the press release said the company's President and Chief Executive Officer would contemporaneously settle to an SEC cease-and-desist order charging him with violating the so-called "non-scienter fraud" provisions of Securities Act Sections 17(a)(2) and 17(a)(3), and that he would pay a \$1 million civil penalty and an unspecified amount as "disgorgement" of gains from his options.

The SEC staff's tentative settlement with Analog Devices is interesting, yet of limited predictive value. Most importantly, nearly a year after the company announced the tentative deal, it still has not been publicly announced by the Commission, strongly suggesting that the Commission rejected the staff's recommendation for one or more reasons. There are several obvious reasons why the settlement may have received a chilly reception at the Commission level, including: (i) the company's conclusion that no restatement of financial results was required; (ii) a statute of limitations that would legally preclude the imposition of monetary penalties based on conduct more than five years old;¹² (iii) the publicly expressed skepticism of one Commissioner about whether minor options timing issues or spring loading should ever result in SEC enforcement action;¹³ and (iv) the SEC's intervening policy statement on imposing monetary penalties against public companies, which made clear the Commission's belief that, generally speaking, such penalties are disfavored in cases where the company's shareholders received no "improper benefit" from the conduct in question.¹⁴ Adding to the intrigue was the company's May 24 press release announcing receipt of a document subpoena from the U.S. Attorney for the Southern District of New York that apparently related to the same stock option issues being investigated by the SEC.¹⁵ That press release again mentioned the

company's tentative settlement with the SEC, but suggested that the case has been narrowed down to focus on only the most recent instance of spring loading (in November 2000) and the most recent instance of backdating (in July 2001), and thus that the SEC may have abandoned all of the remaining charges (including the only charge of postdating options).

Clues from Other Executive Compensation and Perks Cases

In the end, some of the best clues about the SEC's likely charging theories and remedies expectations for options backdating cases may be found in the agency's more numerous cases involving other aspects of executive compensation disclosure. These cases include prominent ones brought against former senior executives of Tyco International Ltd. in September 2002 and against Tyco itself in April 2006;¹⁶ against General Electric Co. in September 2004;¹⁷ against The Walt Disney Co. in December 2004;¹⁸ and against Tyson Foods, Inc. and its former chairman in April 2005.¹⁹ In each of these cases, the core charges were that the company's proxy disclosures about its executives' compensation and perquisites were inaccurate and incomplete in violation of Exchange Act Section 14(a) and the rules thereunder, and that those disclosures were repeated (or incorporated by reference) in the company's annual reports on Form 10-K, thus also violating Exchange Act Section 13(a) and Rule 13a-1. Individuals, when charged, have typically been accused of either aiding and abetting (or, in administrative proceedings, of "causing") the company's violations and, with respect to two of the Tyco defendants, of falsifying company books and records in violation of Exchange Act Section 13(b)(5) and Rule 13b2-1 and misleading the company's accountants in violation of Exchange Act Rule 13b2-2.

Significantly, many of the settled cases in this area have been resolved with administrative cease-and-desist orders rather than with federal court injunctions, and many have not included either securities fraud charges under Securities Act Section 17(a) and Exchange Act Section 10(b) and Rule 10b-5 or the payment of any monetary penalties. One notable exception was the Tyco case, which included wide-ranging financial fraud allegations going well beyond the executive compensation disclosure allegations, and in which the individual defendants

contested the SEC's charges. It should also be noted that in the Tyson case, unlike in the General Electric and Walt Disney cases, both the company and the individual executive agreed to pay civil penalties for their non-fraud violations, and thus had to consent to the filing of a parallel complaint in federal court that mirrored the allegations of the SEC's administrative order, because such penalties could not be imposed administratively.

These executive compensation cases – supplemented with the options-backdating cases brought thus far by the SEC and other public statements from the SEC and individual Commissioners – suggest several potential nuggets for consideration in pending and future options-backdating cases.

First, the core charges in such cases will likely continue to be proxy disclosure violations under Exchange Act Section 14(a) and the rules there under, along with annual report disclosure violations due to the inclusion or incorporation by reference of the same information in a company's Form 10-K. Second, where the conduct is limited to stock option dating issues that are not egregious and not part of a larger accounting fraud case, there is reason to hope that the case can be resolved by an administrative cease-and-desist order without fraud allegations and without the imposition of monetary penalties, at least as to the company. Third, cases limited to option grants that occurred more than five years ago, or that involve only spring loading or minor discrepancies in dates and documentation, may be generating far less enthusiasm at the Commission level than at the staff level, and thus may warrant a persuasive Wells submission rather than a premature settlement offer.

Notes

1. SEC Chairman Christopher Cox, Testimony Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, Sept. 6, 2006 (transcript available at www.sec.gov/news/testimony/2006/ts090606cc.htm).

2. *United States v. Gregory L. Reyes, et al.*, No. 06-CR-70450 (N.D. Cal.) (criminal complaint filed July 20, 2006); *SEC v. Gregory L. Reyes, et al.*, No. 06-CV-4435 (N.D. Cal.), SEC Litigation Rel. No. 19768 (July 20, 2006). The government's joint press release is available at www.sec.gov/news/press/2006/2006-121.htm.

3. The same defendants have since been indicted by a grand jury in the Northern District of California. The indictment added charges of conspiracy, aiding and abetting, and falsification of accounting records. *United States v. Gregory L. Reyes, et al.*, No. 06-CR-70450 (N.D. Cal.) (indictment filed August 10, 2006).

4. *SEC v. Peregrine Systems, Inc.*, No. 03-CV-1276 (S.D. Cal.), Complaint filed June 30, 2003 at ¶ 29.

5. *SEC v. Peregrine Systems, Inc.*, SEC Litigation Rel. No. 18205A (June 30, 2003).

6. *SEC v. Peregrine Systems, Inc.*, SEC Litigation Rel. No. 18290 (Aug. 14, 2003).

7. *SEC v. Symbol Technologies, Inc., et al.*, No. 04-CV-2267 (E.D.N.Y.), SEC Litigation Rel. No. 18734 (June 3, 2004).

8. *SEC v. Symbol Technologies, Inc., et al.*, No. 04-CV-2267 (E.D.N.Y.), SEC Litigation Rel. No. 19585 (March 2, 2006).

9. *In the Matter of Leonard Goldner*, SEC Admin. Proc. File No. 3-12217, SEC Exchange Act Rel. No. 53375 (Feb. 27, 2006).

10. See Press Release, United States Attorney's Office for the Eastern District of New York, Oct. 27, 2004, available at www.usdoj.gov/tax/usaopress/2004/txdv042004oct27a.htm.

11. *Analog Devices Announces Tentative Settlement of the SEC's Previously Announced Stock Option Investigation*, press release dated Nov. 15, 2005 (available at www.analog.com/en/press/0,2890,3%255F%255F88325,00.html).

12. See generally 28 U.S.C. 2462; *Johnson v. SEC*, 87 F.3d 484, 488 (D.C. Cir. 1996).

13. See Paul S. Atkins, *Remarks Before the International Corporate Governance Network 11th Annual Conference*, July 6, 2006 (available at www.sec.gov/news/speech/2006/spch070606psa.htm).

14. *Statement of the Securities and Exchange Commission Concerning Financial Penalties*, SEC Press Rel. No. 2006-4, January 4, 2006 (available at www.sec.gov/news/press/2006-4.htm).

15. *Analog Devices Receives Subpoena*, Press Rel. dated May 24, 2006 (available at phx.corporate-ir.net/phoenix.zhtml?c=95455&p=irol-newsArticle&ID=860224).

16. *SEC v. Dennis Kozlowski, et al.*, No. 02-CV-7312 (S.D.N.Y.), SEC Litigation Rel. No. 17722 (Sept. 12, 2002); *SEC v. Tyco Int'l Ltd.*, No. 06-CV-2942 (S.D.N.Y.), SEC Litigation Rel. No. 19657 (April 17, 2006).

17. *In re General Elec. Co.*, SEC Admin. Proc. File No. 3-11677, SEC Rel. No. 34-50426 (Sept. 23, 2004).

18. *In re The Walt Disney Co.*, SEC Admin. Proc. File No. 3-11777, SEC Rel. No. 34-50882 (Dec. 20, 2004).

19. *SEC v. Tyson Foods, Inc., et al.*, No. 05-CV-0841 (D.D.C.), SEC Litigation Rel. No. 19208 (April 28, 2005); *In re Tyson Foods, Inc., et al.*, SEC Admin. Proc. File No. 3-11917, SEC Rel. No. 34-51625A (April 28, 2005).