

## **Leaks and laxity in ESOP regulations**

***How companies are using loopholes and a poor law enforcement machinery to enable their brass to increase the value of their stock options***

***One US study found that 29% of companies surveyed fudged grants to their top executives***

### **Prithvi Haldea**

Fraudsters continue to find new ways to cheat the system by either committing straight frauds or by exploiting regulatory loopholes and negligence. Even the good intentions of regulators may not be enough to stem malpractices in the absence of proper enforcement. Take the case of the Sarbanes-Oxley Act, passed in August 2002 to plug a number of gaps misused by corporates. The Act has been rendered toothless due to issues of non-enforcement and simple negligence at the regulatory level. One example is stock options.

### **The Backdating bogie**

The Act had tried to stem the malpractice of backdating by making it mandatory for companies to report stock option grants within two days. The move, however, did precious little to eliminate the practice; one study has found that about 24 per cent of stock option grants were reported late and no one bothered.

A recent study by Indiana University's business school estimates that 18.9 per cent of unscheduled grants to top executives from 1996 through 2005 were backdated or manipulated. As many as 2,270 firms -- 29.2 per cent of the sample -- manipulated grants to top executives during this period. Is the practice of backdating more widespread than this? Only time will tell.

More than 100 probes are on now, including against reputed ones like Apple. Top CEOs had earlier argued against accounting rules that would make options a cost to the company. Now they have resorted to backdating!

How does backdating help? A stock option holder has the right to buy shares in the future at a fixed strike price, normally set as the market price of the shares on the date the option is granted. Several instances have been discovered where options were awarded on one date, but the grant date was set earlier to precede a rally in the shares, locking in profits for the option recipient.

Stock options by themselves are not controversial. A useful tools to recruit and retain good employees, they tend to align employees' interests with shareholders. Millions of Americans hold stock options, including top CEOs. Why else would Apple CEO Steve Jobs, Yahoo CEO Terry Semel, and Google CEO Eric Schmidt only ask for \$1 in salary? In fact, the fair value of options awarded by S&P 500 firms alone in 2000 was a staggering \$104 billion. The compensations of senior employees have grown bigger by the day. The issue now is whether some top executives committed fraud when obtaining options.

Backdating is not necessarily illegal, if everything is up-front. The fraud lies in instances where full disclosures, including payment of extra applicable taxes, and earnings statements reflecting the modified grant dates, have not been made to shareholders.

Many companies are now restating earnings, as backdated options essentially provided executives with extra compensation, which is an expense that must be provided for. Broadcom, will take a charge of at least \$750 million against profits it has reported since 2000! The scandal has also forced many companies to delay their quarterly reports for June.

### **Loaders and dodgers**

Also under scrutiny is spring-loading, which is almost the opposite of backdating. Stock options are awarded just before positive news is announced. The stock appreciates and the value of the options rise. This is both an insider-trading and an accounting issue. Then, there is bullet-dodging, where dates are set to follow a negative announcement.

Should we worry? Surely, stock options are popular here too; during May and June alone, 55 companies granted options valued at Rs 360 crore. Ironically, the law encourages backdating. Clause 25 of the listing agreement say a company should promptly notify the exchange of the number of shares covered by options, its terms and the timeframe of exercise. However, as 'promptly' is not defined, backdating is easy.

How can an Indian company misuse this loophole? Say, the share price of a company is Rs 100 on August 1, and moves to Rs 150 on August 16. The company can backdate its compensation committee meeting to August 2, use the August 1 price as prescribed by Sebi, and grant options at Rs 100. It then reports this to the exchange on August 17. If there is a query, the company will take a plea of oversight, as no time limit exists.

To find the extent of this fraud in India, a study could be commissioned to see if an unusual number of stock option grants were clustered when stocks were trading low.

On the regulatory front, companies should be mandated to report grant of options within 24 hours of the board/committee ratification. This should be monitored by the exchanges. Disclosure to the exchanges should include the names of option

recipients and reason for the grant. This information should be made public on exchanges' websites.