"The Ethics of Backdating Stock Options"

Mark S. Schwartz (York University) & Avshalom M. Adam (College of Management)

The ethics of backdating stock options can be considered to be an offspring of the attempt to resolve the agency problem, i.e., the potential conflict of interest that exists between the owners of a corporation and its executive management. In attempting to mitigate the conflict, executives were granted immense compensation packages, typically incorporating stock options. Executive compensation packages became so excessive over recent years that the topic has reached new levels of significance for corporate boards, shareholders, and regulatory authorities. Currently, concerns over executive compensation practices appear to be focused not on excess, but on the breach of executives' fiduciary duties as illustrated in their active role in the practice of backdating stock options. By granting managers the right (or option) to later buy their firm's stock (after a vesting period, typically at least one year) at a fixed price (typically set as the stock's closing price on the grant date), it was initially believed that the agency problem would be mitigated by tying managers' interests to those of the firms' owners (i.e., to maximize their firm's share value). Unfortunately however, many are now coming to the opinion that stock options might be more of the problem, rather than the solution, to the agency problem.

Backdating stock options by executive management was researched recently by Professor Lie[1] who demonstrated a striking pattern. Lie observed that share prices tended to fall just before the options' grant date, and would rise shortly afterward, suggesting that executives were 'backdating' their options by picking a date when the stock's market value was the lowest. By doing so, executives were often able to immediately reap millions of dollars in additional compensation. Following reports of Lie's research in *The Wall Street Journal*,[2] U.S. regulatory authorities began investigating the backdating options practices of over one hundred publicly traded companies, including Comverse, Apple, as well as the Canadian firm Research in Motion. As a result, dozens of companies have been required to wipe out approximately US$5 billion in combined profits through financial restatements, while concurrently dealing with executive resignations and civil lawsuits.[3]

Due to its importance to the field of corporate governance, our paper will examine the ethical issues involved in the principal-agent relationship as is manifested in the backdating of stock options. First, we discuss the history, nature, and possible extent of the attempt to solve the potential conflict of interest by granting stock options and its failure as is manifested in the practice of backdating stock options. Second, the possible advantages and rationale for the practice is presented, including its potential legality (e.g., if properly accounted for), the ability to better attract high quality executives, and the lack of any identifiable stakeholders who are directly harmed. Third, the potential ethical concerns are discussed, at two levels: (1) the micro-level in terms of the relationship between management and owners; and (2) at the macro-level with respect to the unintended consequences to the stock market by and large. The former level relates to the potential for deception and lack of transparency, the potential negative impact to the firm if managers are actually able to control their own levels of compensation, and the perceived unfair advantage over others in being able to use one's privileged position to benefit from changes in share price. At the latter level, we discuss how this practice can increase the uncertainty of investors in the reliability and integrity of the stock market.

Based on our ethical analysis, the paper concludes with managerial implications, such as recommending that executives around the world refuse additional compensation on the basis of backdating stock options, irrespective of the potential legality of the practice. Rather, we suggest that managers would best fulfill their fiduciary obligations by merely accepting as compensation their salary, bonuses, and the provision of their firm's fully vested shares. In addition, boards of directors, with the ultimate ethical responsibility over the firm, might also take steps to better ensure that such discretionary practices involving options are not taking place. These measures should decrease the level of uncertainty in the stock market due to the practice of backdating options