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The impacts of SOX and SEC investigation on the corporate governance of option backdating firms

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ABSTRACT

This study investigates the combined impact of the Sarbanes–Oxley Act of 2002 (SOX) and the subsequent related Securities and Exchange Commission's (SEC) initiatives on the corporate governance characteristics of firms that had historically backdated stock options. Our results show that backdating firms had both weaker board-level and committee-level corporate governance characteristics than control firms in the pre-SOX period. In contrast, backdating firms dress up their board-level governance to meet regulatory requirements but still feature weaker committee-level corporate governance in the post-SOX era.

1. Introduction

The purpose of this study is to investigate changing corporate governance characteristics in the wake of the Sarbanes–Oxley Act of 2002 (SOX) and related subsequent SEC initiatives[3] on firms that historically backdated stock options. Stock-option backdating occurs when stock-option grants are dated to an earlier period/date when the stock price was lower. Backdating results in a lower exercise price for the option recipients to the disadvantage of the issuing company's stockholders. Backdating is inherently deceptive and manipulative; and, as such, highlights poor corporate governance.[4]

Prior to SOX, stock-option granting practices were lax. Furthermore, the filing period for insiders to report receiving stock-option grants was late: 45 days after fiscal year end. SOX and the national securities exchanges now require companies to have fully independent directors on their compensation committees[5] to oversee executive compensation and halt option backdating, and the SEC requires stock options to insiders to be reported within two business days.

Previous studies (e.g., Bebchuk, Grinstein, & Peyer, 2010; Collins, Gong, & Li, 2009; Minnick & Zhao, 2009) have linked backdating to firms with weaker corporate governance. Specifically, Collins et al. (2009) find that less independent boards and boards with a higher percentage of directors selected by incumbent CEOs associate with backdating practices; and Minnick and Zhao (2009) find that directors whose option values are more sensitive to stock prices associate with backdating firms. In addition, Bebchuk et al. (2010) find that lucky options (options granted at the lowest price in the month and hence guaranteed to rise in value) are more likely to be backdated. Bebchuk et al. (2010) further report that board directors oftentimes appear complicit as they are likely to receive backdated stock options at the same dates as their CEOs when the companies have entrenched boards.

In contrast to previous studies (e.g., Bebchuk et al., 2010; Collins et al., 2009; Minnick & Zhao, 2009), this study investigates the exogenous link between regulatory reform on changing corporate governance and backdating practices. While Heron and Lie (2009) and Huang and Lu (2010) find that unscheduled grant dates have an association with backdating even after the passage of SOX, we expect that compensation committee-governance characteristics are associated with backdating practices even in the post-SOX era.

We use 816 firm-year observations to compare the changing corporate governance characteristics of the backdating firms to those of the control group (non-backdating firms) between pre- and post-SOX periods. Furthermore, we use nine dummy corporate governance measures to construct three summary scores[6] for examining what level of corporate governance firms was manipulated for backdating schemes. The three summary scores are firm-level, board-level, and

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[1] Tel.: +1 443 885 3175.
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[3] The SEC has investigated more than 180 companies that might have been involved in stock-option backdating schemes.
[4] See the Securities and Exchange Commission v. Jacob ("Kobi") Alexander, David Kreinberg, and William F. Sorin, the United States District Court for the Eastern District of New York, Civil Action No. 06-CV-3844 (GJ) (E.D.N.Y. August 9, 2006).
[5] Refer to director independence in Section 303: subsections (A4), (A5), (A6), and (A7) of the New York Securities Exchange; and Rule 4350: subsections (c) and (d) of the National Association of Securities Dealers.
[6] The classification details of corporate governance variables and the three summary scores are defined in subsection 3.2.

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committee-level summary scores. The higher the summary governance score, the weaker the corporate governance is, which indicates that a firm is more likely to be involved in a backdating scheme.

Our findings show that backdating firms had both weaker board-level and committee-level summary governance scores than control firms in the pre-SOX period. In the post-SOX era, backdating firms dress up board-level corporate governance but still feature weaker committee-level corporate governance. Especially, backdating firms still use unscheduled dates to time option grants although they change leadership by replacing founder–CEOs. In addition, we find that backdating firms grant a higher percentage of stock options to their CEO compensation than control firms in the post-SOX era.

Our study contributes to the corporate governance literature in three aspects. First, we complement previous studies (e.g., Bebchuk et al., 2010; Collins et al., 2009; Minnick & Zhao, 2009) by investigating the combined impact of SOX and the SEC initiatives on changing corporate governance and backdating practices. Second, we decompose our governance measures into three summary scores to examine what level of corporate governance firms was manipulated for backdating. Third, we use the IRRC (currently RiskMetrics) data to corroborate our hand-collected data and conduct different tests to verify our findings.

In the next section, we review the literature and develop our hypothesis. In Section 3, we describe our research design, sample collection procedures, and operational definitions of the observed variables. We present our descriptive statistics and empirical results in Section 4 and conclude our findings in Section 5.

2. Literature and hypothesis development

Powerful CEOs use their talent, performance, tenure, or shareholdings to influence boards and bargain for more compensation and less independent boards (Boone, Field, Karpoff, & Raheja, 2007). Prior to SOX, there was no mandatory requirement of fully independent compensation committee to oversee stock-option granting practices and the reporting window of receiving option grants was lax. To reduce backdating opportunities, SOX requires companies to have independent boards and committees, and the SEC cuts the filing days of reporting option grants from ten days to two days.[7] However, both Lie (2005) and Heron and Lie (2007) find that the frequency of option backdating has been mitigated but not terminated after SOX. Retrospectively, Heron and Lie (2009) estimate that 18.9% of unscheduled, at-the-money grants to top executives during the period 1996–2005 were backdated or manipulated. Furthermore, Narayanan and Seyhun (2006) find that about 10% of stock-option grants were reported late by over a month in the post-SOX period.

The SEC initiated its backdating investigation in late 2005 and adopted a set of new executive compensation disclosure rules in December 2006.[8] The disclosures of backdating and the SEC investigation on backdating schemes had a huge, detrimental effect on the shareholder wealth of backdating firms. Bernile and Jarrell (2009) find that alleged firms experienced significantly negative abnormal market returns, and the loss was attenuated when the tainted managers were replaced. Becker and Lu (2007) suggest that the total loss in the market value of alleged firms could reflect both the severity of the backdating problems and the extra cost, and that as much as one-third of this loss might be attributable to the SEC regulatory involvement. Furthermore, many backdating firms became takeover targets. Apparently, backdating firms paid a heavy price for their actions. However, Huang and Lu (2010) show that firms still use unscheduled grant dates for timing option grants to future stock returns in the post-backdating-scandal period.

It is plausible that backdating firms could dress up their companies' boards by having independent directors to meet the independence requirements of SOX in the post-SOX period. Likely, backdating firms reconstructed their board structures to avoid their boards' internal investigation, the SEC investigation, and potential lawsuits during the SEC initiatives on backdating schemes. On the other hand, CEOs of backdating firms could influence their boards through other governance loopholes for timing stock-option grants in the post-SOX era. To test the depth of CEOs' influence over their boards and subcommittees in the process of option backdating, we make the following assumptions: that backdating firms dress up their board-level corporate governance to meet the regulatory requirements of SOX; and that they manipulate compensation committee-level governance, which is mostly not mandated by SOX, to continue their backdating practices. Therefore, our alternative hypothesis is the following.

H1. Backdating firms have weaker committee-level corporate governance measures than non-backdating firms in the post-SOX era.

3. Sample, method, and variables

3.1. Sample selection procedures

Backdating schemes presumably started in the 1990s and faded away when the SEC initiated its investigation in late 2005 through 2007. This study focuses on the combined impact of SOX and the SEC initiatives on changing corporate governance and backdating practices. Firms were required to disclose their director independence by 2004 to meet the disclosure compliance deadline of SOX, and backdating firms might reconstruct their governance measures during the SEC investigation on backdating schemes. Therefore, we choose 2000–2001 as the pre-SOX period to compare to the post-SOX era with two distinctive periods: 2004–2005 as the post-SOX period and 2007–2008 as the SEC investigation period. Especially, we hand-collect the corporate governance measures including CEO compensation and CEO ownership for both backdating and control firms from their proxy statements in the three observed periods.

Our samples of backdating firms come from two sources: 141 backdating firms are from the *Wall Street Journal* (WSJ), which has disclosed backdating firms that have been investigated by the SEC, and 47 firms come from D & O Diary's 'counting options backdating lawsuits' to complement the WSJ samples.[9,10] In total, we initially have 188 backdating firms. To ensure that each observed backdating firm was under SEC investigation, we check their 2005–2007 proxy statements related to the backdating investigation disclosures. Of the 188 firms, ten are excluded due to a lack of financial data, leaving 178 backdating firms with available data from Compustat. We focus on the stock-option backdating of U.S. firms. Therefore, five foreign firms and 12 firms without any CEO stock options granted during the three observed periods are excluded.[11] Furthermore, we delete two firms that announced the use of SFAS 123R to expense their stock options

[7] Prior to SOX, Form 5 must be filed if an insider who has conducted insider transactions during the year that were not previously reported via the Form 4 submission. Form 5 is the annual statement of insider beneficial ownership. Form 5 submissions are due to the SEC no later than 45 days after the company's fiscal year ended or within six months after an insider ends his or her affiliation with the company. Form 4 is a statement that insiders, a company's officers, directors, and beneficial owners, who have more than ten percent of ownership, must file a change of ownership with the SEC as defined in Section 12 of the Securities Exchange Act of 1934. Prior to SOX, the reporting window is within ten days following the end of each month. Today, stock option recipients must report their options to the SEC on Form 4, which is due in two days instead of ten days after the SEC adopted new rules to the accelerated Section 16 of the Exchange Act on August 27, 2002.

[8] Refer to the SEC's "Executive Compensation Disclosure:" 17 CFR Parts 228 and 229; Release Nos. 33-8765, 34-55009; and File No. S7-03-06.

[9] See http://dandodiary.blogspot.com/2006/07/counting-options-backdating-lawsuits.html.

[10] See the WSJ at http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html on September 4, 2007. We also locate sample firms' backdating periods from articles published in the WSJ.

[11] That is, there were no new stock options granted, exercisable, non-exercisable, or realized option grants disclosed in the firm's proxy statement in these three periods.