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UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING and URBAN AFFAIRS
Options Backdating Hearing
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INTRODUCTION

I am Kurt Schacht, the Executive Director of the CFA Centre for Financial Market Integrity, the advocacy arm of CFA Institute. I would like to thank Senator Shelby, Senator Sarbanes and other members of this committee for the opportunity to speak to you today on the topic of stock option practices, in particular backdating of option grants. This issue raises important shareholder concerns and we are supportive of your committee taking a closer look, as well as the work of Chairman Cox and the Securities and Exchange Commission (SEC) to investigate alleged abuses.

First, some background about CFA Centre and its parent organization, CFA Institute. CFA Institute is a non-profit professional membership organization with over 84,000 members in 128 countries. Its mission is to lead the investment profession globally by setting the highest standards of ethics, education, and professional excellence. CFA Institute is most widely recognized as the organization that administers the CFA examination and awards the CFA designation, a designation that I share with nearly 68,000 investment professionals worldwide. I direct the advocacy efforts of CFA

Institute through the newly created CFA Centre for Financial Market Integrity, which develops research, education projects and promotes ethical standards within the investment industry.

THE CFA CENTRE PERSPECTIVE: OPTIONS BACKDATING

Our organization approaches this topic primarily as an investor advocate with a focus on protecting shareholder interests and ensuring accurate and transparent financial reporting. We were an early voice for the SEC to amend its newly released executive compensation disclosures to deal with the practice of option backdating and its companion practice of "spring-loading." Both have been prevalent for years and have generally gone unnoticed. In some cases, these practices have been purposefully hidden from shareholder view. The recent focus by various academic studies and the resulting regulatory investigations into the backdating practices have confirmed what is at best, the latest executive compensation controversy and at worst, a growing financial reporting scandal.

Historically, the rationale for granting stock options to executives and other employees was to align their interests with shareowners, and to provide an incentive for them to enhance shareholder value. Several commentators have suggested that even backdated options continue to have such attributes and that the backdating controversy is overblown with politics and rhetoric. They would have us believe it is a "victimless" infraction. In our view, the practices of backdating and spring-loading are unethical manipulations of the option granting process designed to increase employees' compensation to the detriment of shareowners. These practices have been secretive and have placed numerous

companies at significant financial and leadership risk. As with most company scandals resulting in significant cost and uncertainty, it is the public shareowners that fall victim.

We remain concerned about the ultimate scope of the backdating problem. Specifically, is this activity limited to the 100-plus firms under formal investigation or does it extend to a much larger group? For a variety of reasons, including the recent public outrage, the requirements of FASB Statement 123R and APB Opinion 25, the Sarbanes Oxley requirement to file accelerated Form 4's and the new SEC compensation disclosure rules, backdating itself may be yesterday's problem. However, the degree of necessary "clean-up" due to the vast number of companies and the size of stock options incentives in 1990-2002, seems to be unknown. It represents an overhang for individual companies for sure, but more problematic, it must not become a sequel to the lost confidence in financial reporting experienced earlier in this decade.

One mitigating factor may be that in recent months, the use of stock options has fallen out of favor due partly to the new option expensing rules. Whether we consider long term effects or short term effects of backdating and spring-loading, options use has become more rationalized. What this may signal however, is a need for further examination of the "replacement" for options, the practice of granting restricted stock. We should be certain that the gaming of grant dates or material information has not become part of the calculus for this now more favored type of stock incentive.

One final point of perspective relates to the ethical implications of backdating. This controversy comes at a time when executive compensation practices in general, are under intense scrutiny. These latest revelations concerning backdating and spring-loading certainly appear to be yet more practices intentionally conducted under the radar, for obvious reasons. It leaves many wondering about the respective standards and duties of officers and directors who approved of and even participated in some of these option granting irregularities. This is all the more troubling given that the practice appears to have continued after Sarbanes Oxley was passed in 2002 and suggests that at least some compensation and audit committee members may have been less than diligent in their duties.

ACCOUNTING AND AUDITING PRACTICE - WHAT HAPPENED?

The accounting standard relating to stock option expenses that existed for many years before FASB Statement 123R was clear. APB Opinion 25 allowed companies to avoid a compensation expense only if certain criteria were met. Such criteria clearly included a requirement that the underlying stock price on the date of the grant must be equal to the exercise price of the options. Stated differently, the grant date price and the exercise price must match, in order to avoid the attendant compensation expense.

It is difficult to fashion an argument as to how this might ever happen in the context of backdating an option grant. Therefore, in nearly every case where an option grant date was backdated, a compensation expense was required to be recognized and reported in the company's income statement, unless it was deemed immaterial. As a result, nearly

every company identified in the press as having backdating problems failed to properly record compensation expense for options and thereby filed financial statements that did not comply with the U.S. Generally Accepted Accounting Principles (GAAP) (again, unless the amount of expense was "immaterial").

Viewing this in the context of external auditor responsibilities, it remains unclear how this practice was repeatedly missed or worse, sanctioned. In some cases it may have been sloppiness, incompetence or both. In other cases it may have been an intentional act of concealment by the responsible managers. A number of the accounting firms have suggested that the client company's option documentation was typically taken at face value. Such documentation would generally indicate that the company had granted at-the-money, fixed-plan, employee options, when in fact they had not. This "papering" of the option transactions therefore appeared as though no compensation cost needed to be reported.

Generally, auditors thought that option practice was a low-risk (non cash) area and relied on the client company's records without attempting to verify if such records reflected what actually occurred. We think a clear lesson has now been established. However, we remain concerned whether auditors were actually complicit, turning a blind eye because of client pressures or because it seemed like "every one was doing it" (backdating). We have little doubt that auditors today will acknowledge that backdating typically failed to meet the criteria of APB Opinion 25, that is, recognition of zero expense only for at-the-money options.

It is now the case in over 100 countries around the world that follow either U.S. GAAP or International Accounting Standards rules, that backdating, without expensing of the full fair value of the options, would constitute a violation of accounting standards. Whether because of these new option expensing rules, Sarbanes Oxley, the public furor over backdating or some combination thereof, we must now expect that proper audit procedures would demand a closer look and verification of these options and restricted stock practices. We expect this will be facilitated by the SEC's new executive compensation disclosure requirements.

LINGERING CONCERNS

As we noted above, the companion practice of spring-loading options grants should be further scrutinized. This involves the gaming of grants around the release of material non-public information. Studies suggest this has been rampant for many years and it happens regardless of whether grant dates are fixed annually or at the discretion of management or directors. The protections offered by the Sarbanes Oxley accelerated Form 4 filing, does not address this. While the latest executive compensation disclosure requirements of the SEC do require a full review and report by the compensation committee on any spring-loading activities, it does not prohibit them. We would encourage a closer look at whether officers and directors in control of the option granting process should be barred from participating in any spring-loaded grants, just as they would be prohibited from trading in any other company securities while in the possession of inside information.

We have one additional concern. We believe that one facilitator of backdating was accounting rules that failed to result in fair value expensing of the cost of the options. As we have said, auditors apparently failed to consider such off-balance-sheet (OBS) items of sufficiently high risk to warrant full scrutiny and thorough audits of the option grants. Many more items, several of considerable size relative to most companies' balance sheets, remain off-balance-sheet and unexpensed, and reported if at all, in the notes. We would hope that auditors would learn from the lessons of the 2001-2002 corporate collapses involving large OBS transactions and the backdating/spring-loading problems currently receiving scrutiny and tighten their procedures to make certain that these receive the same attention as items required to be expensed.

CONCLUSION

We commend the members of the Committee for your continued attention and leadership on this unethical industry practice. In summary, we encourage three further steps.

1. Consideration of a possible ban on spring loading for named executives and directors.
2. A closer look by auditors and regulators for any irregularities in the granting process used for restricted stock.
3. A bolstering of audit procedures to include a closer review of any other off balance sheet items posing similar risks of being misreported.

Our markets can ill afford further lapses in the ethics relating to executive compensation or the integrity of financial reporting. We have been down that market–paralyzing road before.