The Option Backdating Scandal of 2006

By Sigalit Noureal

During the 1990s, option backdating came to be considered an economic windfall and a tax loophole to top executives of US companies. This notion began to change following corporate scandals in 2002, most notably that of Enron, Tyco, Adelphia and WorldCom. But what made option backdating a concern for the government, as well as for shareholders, was a writing by Erik Lie, "On the Timing of CEO Stock Option Awards," and a *Wall Street Journal* article published in March 2006 suggesting that executives of six companies might have backdated their stock options.[1] Shortly after the Wall Street Journal publication, criminal indictments and federal investigations bombarded companies, primarily technology and internet companies.[2] Ironically, backdating had been a staple of executive compensation packages for years, yet two publications triggered this latest corporate scandal and caused companies to reevaluate their corporate governance policies. Of course, the story is not that simple. Investor and government distrust of corporate governance has been in the headlines for over five years now.

Today, courts are forced to address the issue of whether option backdating is legal, and if not, what its consequences should be. It has long been understood that backdating was a reasonable means of executive compensation. However, following the federal disclosure and transparency regulations of the Sarbanes-Oxley Act of 2002 (SOX)[3] and the new SEC standards of compensation accounting,[4] such practices are under scrutiny.

---

[1] *See* Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 801, 802 (2005).

[2] The Wall Street Journal maintains a list and updated narrative of all the companies implicated by the backdating scandal. *See* Perfect Payday, *Options Scorecard*, http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html (last visited Mar. 28, 2007).

[3] "Sarbanes-Oxley is considered the most significant change to federal securities laws in the United States since the New Deal. Officially titled the Public Company Accounting Reform and Investor Protection Act of 2002…The Sarbanes-Oxley Act is designed to review dated legislative audit requirements to protect

Many CFOs and other top finance executives have been walking on egg shells since the enactment of SOX. But just as companies have begun to adjust to the corporate governance standards of SOX, a new controversy regarding executive compensation practices threatens corporate stability.[5] Dozens of executives have been forced to resign and many companies have announced that they will have to restate their past financial statements.[6]

<u>What is Option Backdating?</u>

Tax and accounting rules dictate that options are to be issued at-the-money (when the strike price is equal to the market price of the stock on grant date).[7] An option granted at-the-money results in a "zero recognized expense" for company accounting purposes.[8] However, an option granted in-the-money results in a charge to earnings (a compensation expense).[9] Investigations into companies that engaged in backdating indicate that these

---

investors by improving the accuracy and reliability of corporate disclosures, covering issues such as establishing a public company accounting oversight board, corporate responsibility, auditor independence, and enhanced financial disclosure. The act's major provisions mention that we can name the prohibition on insider trades during pension fund blackout periods, the certification of financial reports by CEOs and CFOs, the public reporting of CEO and CFO compensation and profits, accelerated reporting of trades by insiders, and ban personal loans to any Executive Officer and Director. Basically, the act requires full disclosure on just about everything." *What is Sarbanes-Oxley?*, http://www.tech-faq.com/sarbanes-oxley.shtml (last visited Mar. 28, 2007).

[4] In July 2006 the SEC approved the final rules amending the executive and director compensation disclosure requirements. The purpose of the new rules was to provide a clearer and more complete picture of total compensation made by a company's highest paid executive officers and board members. Accordingly, the new regulations require, among other things, (1) a Summary Compensation Table disclosing the dollar value of all equity awards, (2) a Compensation Discussion & Analysis (CD&A) certified by the CEO and CFO, which is supposed to provide a narrative overview of the companies objectives of executive compensation in "plain English," and (3) a discussion by the compensation committee explaining the processes and procedures ("the whys") in determining executive compensation. The new SEC regulations will be discussed in greater depth later in this article.

[5] *See* Joseh Armao, *Options Backdating: Plenty to Worry About*, 22 FIN. EXEC. 8, Oct. 1, 2006.

[6] Lucian Bebhuk et al., *Lucky Directors*, Harvard Law and Economics Discussion Paper No. 573, ISSN 1045-6333 (Dec. 2006 revised January 2007), *available at* http://papers.ssrn.com/abstract_id=952239.

[7] David I. Walker, *Some Observations on the Stock Options Backdating Scandal of 2006*, Boston Univ. School of Law Working Paper Series, Working Paper No. 06-31, at 4, *available at* http:// http://www.bu.edu/law/faculty/scholarship/workingpapers/documents/WalkerD091206.pdf.

[8] Walker, *supra* note 7, at 5.

[9] Walker, *supra* note 7, at 5.

companies were granting in-the-money options but not accounting for them in their financial statements or disclosing them to shareholders.[10]

Option backdating is when the option grant date is retroactively dated to an earlier time when the price of the stock is lower than the actual grant date. Backdating options to a date when the price of stock is lower than the original grant date "allows the corporate insider to eventually purchase the underlying stock at a better price."[11] When stock prices do not rise, stock options become worthless to the holder and lose their incentive value. Backdating fixes this problem by "giving executives the right to buy future shares at today's prices, [it] [o]ffer[s] them the right to buy today's shares at yesterday's prices. The beauty of this policy was that companies could pick whatever yesterday they wanted. They could take the risk out of the stock option."[12]

A classic backdating scenario is as follows. Suppose the CEO of XYZ Inc. is awarded 10,000 options on April 15 by the board of directors when the XYZ's stock price is $40. Suppose XYZ's stock price has been rising before the board's decision to grant the options. The CEO sees an opportunity to increase his compensation and produces documents that declare an at-the-money grant on March 15, when the stock price was below $40, let's say $30. What the board intended was the CEO to receive options on April 15 with a strike price of $40. But, what the CEO declared was that he received the options on March 15 for $30. Effectively, XYZ Inc. granted the CEO an option that is $10 in-the-money. The CEO secretly manipulated documents relating to his option grant because openly granting in-the-money stock options would have negative tax and

---

[10] Walker, *supra* note 7, at 5.
[11] Andrews Derivatives Litigation Reporter, *Bay Area Federal Task Force Targets Stock-Option Backdating*, 12 No. 20 ANDERLR 3, Aug. 20, 2006.
[12] Editorial, *Bitten by Backdating*, L.A. TIMES, Oct. 17, 2006, at California Metro Section.

accounting consequences, which he wanted to avoid. It also may have violated company restrictions on option pricing.[13] "Unlike conventional options, which don't eat into a company's profit, backdated ones count as a charge against earnings. Therefore, they may not be tax deductible."[14]

In David Yermack's article, "Good Timing: CEO Stock Option Awards and Company News Announcements," Yermack found that stock price tended to rise following option grants.[15] Yermack attributed this to opportunistic grant timing.[16] But now we know that option prices rose after option grants most likely because those grant dates were chosen "with hindsight."[17] Backdating was first discovered and introduced by Erik Lie in his article, "On the Timing if CEO Stock Option Awards." He concluded that unless executives were extraordinary prognosticators, some options were being backdated.[18]

Option backdating is a windfall for executives but "shortchanges" the company, because the company gets paid less for its stock.[19] Backdating by itself is not per se illegal so long as it is (1) authorized by the board of directors, (2) fully disclosed and (3) consistent with reporting and tax rules.[20] The reason so many companies are in trouble today is because they backdated in secret. "Falsification or backdating of financial documents may call the integrity of companies' financial statements into question, can

[13] Walker, *supra* note 7, at 6.
[14] Editorial, *Bitten by Backdating*, L.A. TIMES, Oct. 17, 2006, at California Metro Section.
[15] Walker, *supra* note 7, at 7-8.
[16] Walker, *supra* note 7, at 8
[17] Walker, *supra* note 7, at 8.
[18] Walker, *supra* note 7, at 8; *see also* Erik Lie, *On the Timing if CEO Stock Option Awards*, 51 MGMT. SCI. 802 (2005).
[19] 12 No. 20 ANDERLR 3.
[20] *See generally* M.P. Narayanan,et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 8 (forthcoming June 2007); Walker, *supra* note 7, at 31.

constitute fraud on the company, shareholders, and the market, and may give rise to tax violations."[21]

The revelation or even the suspicion of undisclosed backdating has dire affects on investor confidence. The irony of the backdating scandal is that it seems that the potential benefit to executives was miniscule compared to the detriment to shareholders when the activity was revealed.[22] A study from Boston University School of Law indicates that the most an executive profited from backdating from 2002 through 2004 was $600,000 per year.[23] However, this was an extreme scenario—in order to make $600,000, the executive would have had to backdate on every grant date where backdating would have been profitable.[24] Compare this to the economic loss suffered by companies, which lost an average of $510 million in market value during a window of 21 days of the first announcement of potential backdating.[25]

<u>Why was Option Backdating Such a Prevalent Practice?</u>

The companies primarily under fire in the option backdating scandal are America's leading high-tech firms and other publicly traded internet businesses. Many of these companies are located in the Silicon Valley. Some say that Silicon Valley has had a long reputation for being disdainful of shareholder demands for accountability.[26] "They thought they lived by different rules…[t]hey said e-governance was different."[27] The exercise

[21] 12 No. 20 ANDERLR 3.
[22] Walker, *supra* note 7, at 5.
[23] Walker, *supra* note 7, at 5.
[24] Walker, *supra* note 7, at 5.
[25] Walker, *supra* note 7, at 5. The loss per company averaged five hundred and ten million dollars within 21 days of the first announcement implicating a company of backdating either by the company's own admission, or because the SEC or Justice Department commenced an investigation. Walker, *supra* note 7, at 5.
[26] Tom Petruno, *Backdating is Seen as Option in Tech Realm: Silicon Valley Probes are Targeting Practices that Many Consider Legitimate Means to Advance Firms' Goals*, L.A. TIMES, Sept. 10, 2006, at Business Section.
[27] Petruno, *supra* note 26.

price for many of these companies would be set equal to their company's lowest market price that month, quarter, or even that year.[28]

However, for most of these technology companies, stock options and backdating of stock options were a recruiting tool which became the ticket to riches for many of their employees. Companies did not want to lose their top employees in a fiercely competitive job market so they would offer to backdate executive options to a date when stock value was lower. Typically, the value variance between the true grant date and the new grant date was only a few cents per share. But, even a small variance such as 20 cents per share, for example, can be a windfall if the executive has thousands of stock options to exercise. If an employee has 10,000 options, by backdating the grant date to a date when company stock was 20 cents cheaper, the executive is automatically $2,000 in-the-money before he has even exercised his option to purchase the stock.

> In some cases backdating has been defended as a necessary means to level the playing field between employees hired in rapid succession. Imagine that Acme Co. has a volatile stock price; hires Andy on January 1, Beth on January 15, and Cindy on January 30; and the market price of its stock on these three dates was $12, $10, and $15/share, respectively. If Acme grants at-the-money options to its new employees on their hiring dates, Beth receives a windfall, and Andy and Cindy are displeased. Of course, Acme could grant Cindy an option with a $10 strike price on January 30 despite the prevailing $15 market price, but that grant would result in a $5/share charge against earnings and could not qualify as an ISO. Moreover, the expense might not be deductible for Acme if Cindy is a senior executive. [29]

"Apparently the solution for some companies was backdating."[30] Clandestine backdating allows companies to avoid hits to their bottom line. "Unlike conventional options, which don't eat into a company's profit, backdated ones count as a charge against

[28] Walker, *supra* note 7, at 7.
[29] Walker, *supra* note 7, at 6-7.
[30] Walker, *supra* note 7, at 7.

earnings" and are not tax deductible.[31] By concealing their manipulation of grant dates, the employee avoids income taxes and the company misrepresents their expense losses. Had companies, such as the one in the Acme example, fully disclosed this practice, there would be no issue of illegality because it would have been divulged to owners for their approval. But instead, many top executives followed a "whatever it takes to make your options valuable" policy.

There were tax incentives to backdating stock options as well. As mentioned earlier, long-term capital gains are taxed at a lower rate than ordinary income. In order to accelerate a tax benefit on their investment, company employees would backdate their option grants so the sale of their stock would appear to be a long-term capital gain. Instead of waiting one year from the exercise date and two years from grant date, management would change the date to an earlier time so the stock would qualify for the favorable tax consequences.

In hindsight, the divergence between potential executive benefits and company loss is great. But most likely, many executives who engaged in undisclosed backdating did not foresee the devastating aftershock the practice would have on the value of their companies. Just by looking at the time period from the early 1990s to 2002, when option backdating was most prevalent, one can see that backdating was only a small portion of compensation manipulation and company waste that took place.

The scandals involving Tyco International, Enron, WorldCom and Adelphia around 2002 are what brought backdating to the forefront of investor concerns. Enron was under fire because executives did not disclose the dire straights the company was in and tried to

---

[31] Kathleen Pender, *Backdating Scandal has More than 100 Companies in SEC's Sights*, SFGATE, Sept. 7, 2006, http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2006/09/07/BUGEGL0G4P1.DTL.

hide their losses in SPEs.[32] The fall of the most successful energy company was a wake-up call to investors, demonstrating that executives were not fully disclosing company finances and that the executive interest was not aligned with that of the shareholder. The indictments of Tyco CEO Dennis Koslowski and CFO Mark Swartz brought executive compensation into the limelight. Within four years, Tyco CEO Dennis Kozlowski collected $326 million in salary, bonus, stock and other perquisites.[33] This sum exceeds the approximately $300 million in compensation former CEO of Enron, Kenneth Lay, made.[34] Even though backdating was only a small part of the corporate theft conducted by company executives, today it resonates deep with investors as a symbol of corporate greed and dishonesty.

<u>New Regulations in Response to the Backdating Scandal</u>

In response to investor concerns over the quality and transparency of executive compensation, the SEC adopted "sweeping amendments" to its disclosure rules.[35] On January 27, 2006, the SEC published four comment proposed rules amending disclosure requirements for executive and director compensation.[36] Then in July of 2006, the SEC approved the final rules amending those new disclosure requirements.[37] In August of 2006, the final rules on executive compensation and related party disclosure were released and ultimately finalized in December 2006 for the 2007 proxy season.[38] The new

[32] "A special purpose entity (SPE) … is a body corporate (usually a limited company of some type or, sometimes, a limited partnership) created to fulfill narrow, specific or temporary objectives, primarily to isolate financial risk, usually bankruptcy but sometimes a specific taxation or regulatory risk." *Special Purpose Entity*, http://en.wikipedia.org/wiki/Special_purpose_vehicle#_note-0.
[33] Andrew R. Sorkin, *Ex-Tyco Executives Get 8 to 25 Years in Prison*, N.Y. TIMES, Sept. 20, 2005.
[34] *Id.*
[35] Michael O'Brien, *Final SEC Rules Bring Significant Change to Executive Compensation Disclosure*, MONDAQ, Sept. 18, 2006.
[36] O'Brien, *supra* note 35.
[37] O'Brien, *supra* note 35.
[38] O'Brien, *supra* note 35.

regulations do not require companies to restate their earnings for prior fiscal years. Rather, some of the disclosure requirements will only begin to apply for the 2006 fiscal year. Since a majority of the new disclosure requirements will be phased in over a three-year period, (over two years for small businesses) companies will not be forced to adjust to these changes overnight.[39]

The SEC amendments will affect a vast array of corporate statements and filings including proxy statements, annual reports, compensation arrangement reports and certain filings under the Securities Act of 1933 and the Securities Exchange Act of 1934. The SEC is looking to impose requirements that would give shareholders a better understanding of the financial relationship between a company and its executive officers, directors, significant shareholders, and other related persons. Furthermore, the goal of these regulations is "[g]reater transparency and comparability of all the elements of the compensation awarded today's top executives—and ultimately, greater accountability of the individuals enforcing and overseeing those programs."[40] The SEC is looking for companies "not only to disclose the 'whats' of executive compensation, but also the 'whys' behind program designs and decisions."[41] Boards will have to move beyond the typical boilerplate disclosures and move toward a more precise comparison between executive pay and performance.

<u>The Sarbanes-Oxley Act of 2002 Curbed Option Grant Manipulation Years Before the Backdating Scandal Broke</u>

---

[38] O'Brien, *supra* note 35.
[39] O'Brien, *supra* note 35.
[40] Hewitt Associates, *Championing Accountability and Transparency: The New Role of the Compensation Committee*, 2006.
[41] Hewitt Associates, *supra* note 40.

Before discussing in detail the SEC amendments, a comment on the affect Sarbanes-Oxley had on executive option grant manipulation is proper. Option backdating was popular during the technology boom of the 1990s. However, by the time internal investigations and federal indictments over potentially illegal executive compensation practices commenced in 2006, option backdating predominantly ceased in response to the Sarbanes-Oxley Act of 2002.

SOX has caused more confusion and apprehension in corporate America than any other law in recent history. For that reason, the SEC has adopted rules that comply and expand on certain sections of the Act.[42] The SEC rules, which transpired from SOX, require executive officers to certify the maintenance and effectiveness of adequate internal controls as well as to certify that the company's finances are fully itemized and disclosed.[43]

The most significant requirement on option backdating is the imposition of a two-day window in which a company has to report stock option grants to high-level employees following the execution date.[44] Before SOX, certain option grants could be filed 45 days after the end of the company's fiscal year (on a Form 5, an annual disclosure),[45] or within ten days of the following month of the grant date (on a Form 4, a standard disclosure).[46] The SEC adopted new rules, implementing provisions of SOX that accelerate the deadline for filing most insider ownership reports. Form 4 is a statement of change in security

---

[42] *See* Sarbanes-Oxley.com, http://www.sarbanes-oxley.com/section.php (last visited March 28, 2007).

[43] Now CEOs and CFOs have to warrant that information in the annual report, proxy statements and solicitations, and financial statements are accurate. The purpose of imposing personal liability on chief officers is to provide further transparency of company financial conditions and policies. The requirement of executive certification has given rise to the argument that this will hurt the market and corporate business because it drives talented people away from publicly-trade companies. The stringent requirements on financial disclosure and executive compensation may push talented businessmen to work with private or foreign companies instead in order to avoid personal liability imposed by SOX.

[44] James Cox, Testimony before Committee of the Judiciary, United State Senate, on Insider Trading (Sept. 26, 2006).

[45] Form 5, *available at* http://www.sec.gov/about/forms/form5.pdf.

[46] Form 4, *available at* http://www.sec.gov/about/forms/form4.pdf.

ownership filed with the SEC by every director, officer and/or owner of more than ten percent of a class of equity securities.[47] The initial filing of security ownership is filed on a Form 3[48] and all changes are reported on Form 4. The Annual Statement of Beneficial Ownership of Securities is on Form 5. Forms 3, 4 and 5 contain information about the reporting person's relationship to the company and about the sale or purchase of the securities reported.

Form 3 is the Initial Statement of Beneficial Ownership of Securities filed with the SEC by an officer, director, or beneficial owner of the company's securities. Form 3 is typically filed after a company's Initial Public Offering (IPO), when insiders make their first transactions. After a Form 3 is filed, future filings of the same nature are filed under Form 4 or Form 5.

<u>Compensation Discussion and Analysis (CD&A)</u>

The most significant of the new SEC compensation requirements is the new Compensation Discussion and Analysis (CD&A), which will be included in a company's proxy statement for its annual meeting of stockholders or in its Annual Report on Form 10-K,[49] if not incorporated by reference from the proxy statement.[50] The Annual Report on Form 10-K provides a comprehensive overview of the company's financial and business condition.[51] Although similarly named, the Annual Report on Form 10-K is different from the Annual Report to shareholders, which a company sends to shareholders when it holds an annual meeting to elect directors.[52]

[47] SEC Answers, http://www.sec.gov/answers/form345.htm.
[48] Form 3, *available at* http://www.sec.gov/about/forms/form3.pdf.
[49] Annual reports are filed on Form 10-K, quarterly reports on Form 10-Q and current reports on 8-K.
[50] O'Brien, supra note 35.
[51] SEC Answers, http://www.sec.gov/answers/form10k.htm.
[52] SEC Answers, http://www.sec.gov/answers/form10k.htm.

The CD&A replaces the disclosure that used to be included in the compensation committee report and significantly expands its coverage.[53] "The CD&A is a narrative overview explaining the material elements of compensation for a company's named executive officers."[54] The named executive officers include the CEO, CFO plus three other of the most highly compensated executive officers.[55] CD&A should reflect the individual circumstances of the company and avoid boilerplate language.[56] Disclosures must be written in plain English and must be certified by the CEO and CFO.[57]

The CD&A should provide a detailed discussion of each element of executive compensation and describe the outcome it seeks to reward.[58] Perspective needs to be given to each element's role in the company's overall compensation objectives, as well as the balance between current and long-term compensation.

Long-term incentive compensation is generally in the form of equity-based awards that are meant to achieve such goals as "retaining executives, aligning executives' financial interests with the interests of shareowners, and rewarding the achievement of long-term specified strategic goals of the company and/or the superior performance of company stock."[59] To maximize effectiveness and efficiency, compensation committees should carefully evaluate the costs and benefits of long-term incentive compensation.

Option Granting Practices

Corporate policies regarding the timing of option grants must be disclosed. The new SEC rules simplify the disclosure of incentive-based awards so that non-stock grants,

---

[53] O'Brien, *supra* note 35.
[54] O'Brien, *supra note* 35.
[55] Hewitt Associates, *supra* note 40.
[56] O'Brien, *supra* note 35.
[57] O'Brien, *supra* note 35.
[58] Hewitt Associates, *supra* note 40.
[59] *Executive Compensation*, Council of Institutional Investors, http://www.cii.org/policies/compensation/lt_inc_comp.htm (last visited Mar. 28, 2007).

stock-based grants and performance-based awards are all contained on one table.[60] Specifically in regards to the scandal over backdating and grant date manipulation, the new rules require increased disclosure of the company's option granting practices, "including the timing of stock option grants and the determination of exercise prices."[61]

In addition, companies must fully disclose the existence of any plan to time option grants in accordance with an announcement of material non-public information.[62] This practice is referred to as "spring loading".[63] The SEC also indicates that a plan or practice of changing the option strike price to a price on a date other than the actual grant date, must be disclosed in the CD&A.[64] Disclosure of spring loading and backdating in the CD&A is intended to provide greater transparency and minimize unethical option granting practices.

The new rules require the inclusion of two tables relating to holdings of equity-related interests – one disclosing the outstanding equity awards held by each named executive officer at year-end[65] and the other disclosing the value realized upon the exercise or vesting of the stock-based award during the last fiscal year.[66]

In the Outstanding Equity Awards at Fiscal Year End Table, for option awards, the company will be required to disclose the number of vested and unvested[67] securities underlying each award, the exercise price and the expiration date, and will also be required

---

[60] O'Brien, *supra* note 35.
[61] O'Brien, *supra* note 53.
[62] O'Brien, *supra* note 53.
[63] O'Brien, *supra* note 53.
[64] O'Brien, *supra* note 53.
[65] Outstanding Equity Awards at Fiscal Year End Table
[66] Options Exercised and Stock Vested Table
[67] Generally, stock is vested when you have the right to keep it – even if you cannot sell it right away. Stock you receive as compensation is vested if you have the right to keep the stock even if you quit or get fired or if you have the ability to transfer the stock to another person, free from any restrictions. *When Stock is Vested, Tax Guide for Investors*, http://www.fairmark.com/execcomp/vested.htm (last visited March 29, 2007).

to separately disclose for time-based and performance-based awards.[68] For stock awards, the Outstanding Equity Awards at Fiscal Year End Table includes the "number of vested and unvested shares, the number of unearned and unvested shares, and the market or payout value of unearned and unvested shares, with separate disclosures for time-based and performance-based awards."[69] Disclosures regarding stock and option awards on the Outstanding Equity Awards Table must be made on an award-by-award basis.[70]

In the Option Exercises and Stock Vested Table, the company discloses amounts realized by named executive officers for equity compensation for the last fiscal year as a result of option exercises and the vesting of stock awards.[71] The SEC believes this table will give investors a clearer picture of the total amount a named executive officer realizes on equity compensation.

<u>The New Role of the Compensation Committee</u>

Serving as a director of a publicly traded company has never been more demanding or more publicly visible.[72] Since compensation disclosures have become more complex and shareholder scrutiny has increased, board committees have become a "catalyst" to greater transparency and change.[73] Compensation committees are looking to better align incentive compensation with corporate performance.[74] As a result of the backdating scandal, many have replaced stock option grants with restricted shares and performance shares.[75]

[68] O'Brien, *supra* note 53.
[69] O'Brien, *supra* note 53.
[70] O'Brien, *supra* note 53.
[71] O'Brien, *supra* note 53.
[72] Hewitt Associates, *supra* note 40.
[73] *See* Hewitt Associates, *supra* note 40.
[74] Hewitt Associates, *supra* note 40.
[75] *See* Hewitt Associates, *supra* note 40.

"The new disclosure rules require the compensation committee to discuss the process and procedures used in determining executive and director compensation."[76] The compensation committee must disclose and describe in detail when it has designated any of its authority to executive officers and what role such officers had in determining compensation.[77] Consultants that have advised in the company's compensation process must also be identified, as well as who dealt with them—the compensation committee or management.[78]

Following the new disclosure rules, the compensation committee must complete a Compensation Committee Report (Report).[79] The Report states that the compensation committee has reviewed the CD&A with management, and based on that review, the committee has recommended to the board of directors that the CD&A be included in the company's annual financial statement and in its proxy statements.[80] Also, NASDAQ Rule 4350(c)(3) requires compensation committee members be completely comprised of independent directors, i.e. those directors who are not employees or officers of the company or its subsidiaries, nor have a relationship which, in the opinion of the board, would interfere with the exercise of independent judgment in carrying out their responsibilities as directors.[81]

In Conclusion

Even though corporate America has lost investor confidence due to corporate scandals, American companies can still do their part to regain this confidence. Many

---

[76] Hewitt Associates, *supra* note 40.
[77] Hewitt Associates, *supra* note 40.
[78] Hewitt Associates, *supra* note 40. Compensation consultants are in high demand as a result of the new regulations.
[79] Hewitt Associates, *supra* note 40.
[80] Hewitt Associates, *supra* note 40.
[81] *See* Corporate Governance Certification Form_1206. The NASDAQ Stock Market.

companies have already begun to implement internal controls to show investors they are serious about reforming their corporate governance practices and are committed to holding corrupters accountable. Ways to increase investor confidence include, but are not limited to: (1) launch internal investigations before the SEC begins a company investigation; (2) use utmost speed to reform their compensation and accounting practice; (3) restate financials quickly; (4) terminate and replace management; (5) institutionalize certain practices to make sure backdating does not happen again; and (6) reduce executive compensation.

The detailed information, which will be provided as a result of these new compensation disclosure standards, will force corporations to make better decisions in setting the appropriate amount to pay the people running the company. On the other hand, corporations will be reluctant to pay what some of these executives deserve so they won't be sued for waste and fraud. Case law and federal regulations on executive compensation issues are evolving and developing. Some critics say that fraud shows that "no level of regulation or oversight may be enough to stop someone who is intent on a way around the law…[i]f someone really wants to commit fraud they can do it."[82]

[82] Tom Petruno, *Filings Allege Tactics to Hide Backdating of Stock Options*, L.A. TIMES, Aug. 13, 2006.