NASPP San Diego Chapter

The Backstory on Option Backdating:

Going Behind the Headlines

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November 2, 2006

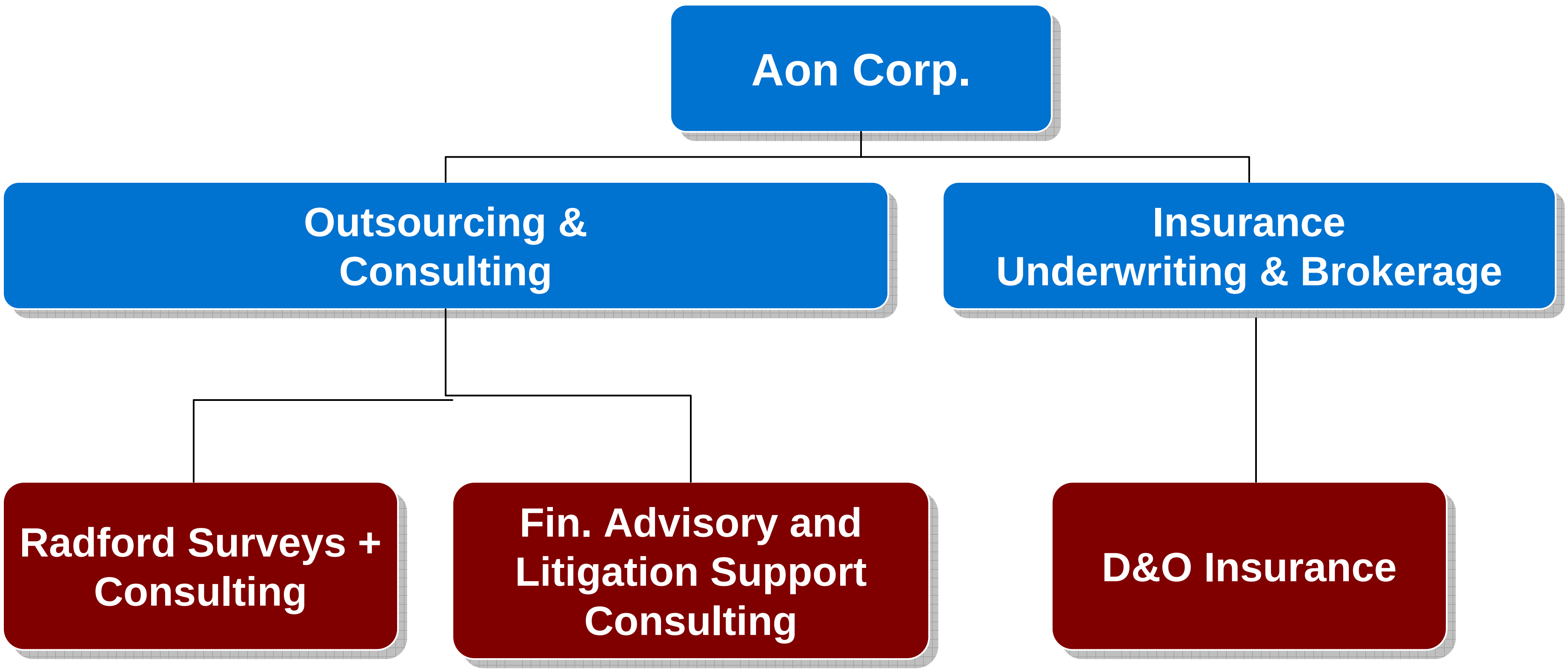
Agenda

- Introductions/Thanks to Biosite for Hosting
- Background
- Current Guidance and Accounting Case Study
- Collateral Damage
- Remedies
- D&O Insurance Considerations
- Q&A

Thank you for inviting us today

- Xavier Oustalniol
  - Managing Director, Aon's Financial Advisory and Litigation Consulting Services
  - Specializing in forensic accounting, litigation support, high-tech investigations and information security consulting, corporate investigative services and e-discovery
- Robert W. Smith
  - Senior Vice President, Aon Financial Services Group
  - Expertise in all phases of complex Directors & Officers Liability exposure analysis, brokerage, and policy language negotiation
- Matt Ward
  - Senior Vice President, Radford Surveys + Consulting, a business unit of Aon
  - Specializing in incentive and equity compensation consulting

For this topic, we bring multiple perspectives to the table



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Background

Chronology of events

May 2005 – Professor Lie (University of Iowa) study: *On Timing of CEO Stock Option Awards*

July 2005 – Mercury Interactive investigated

August 2006 – Comverse Technology executives indicted

November 2005 – WSJ and national media scrutiny begins

1997 – First academic studies on option timing

July 2006

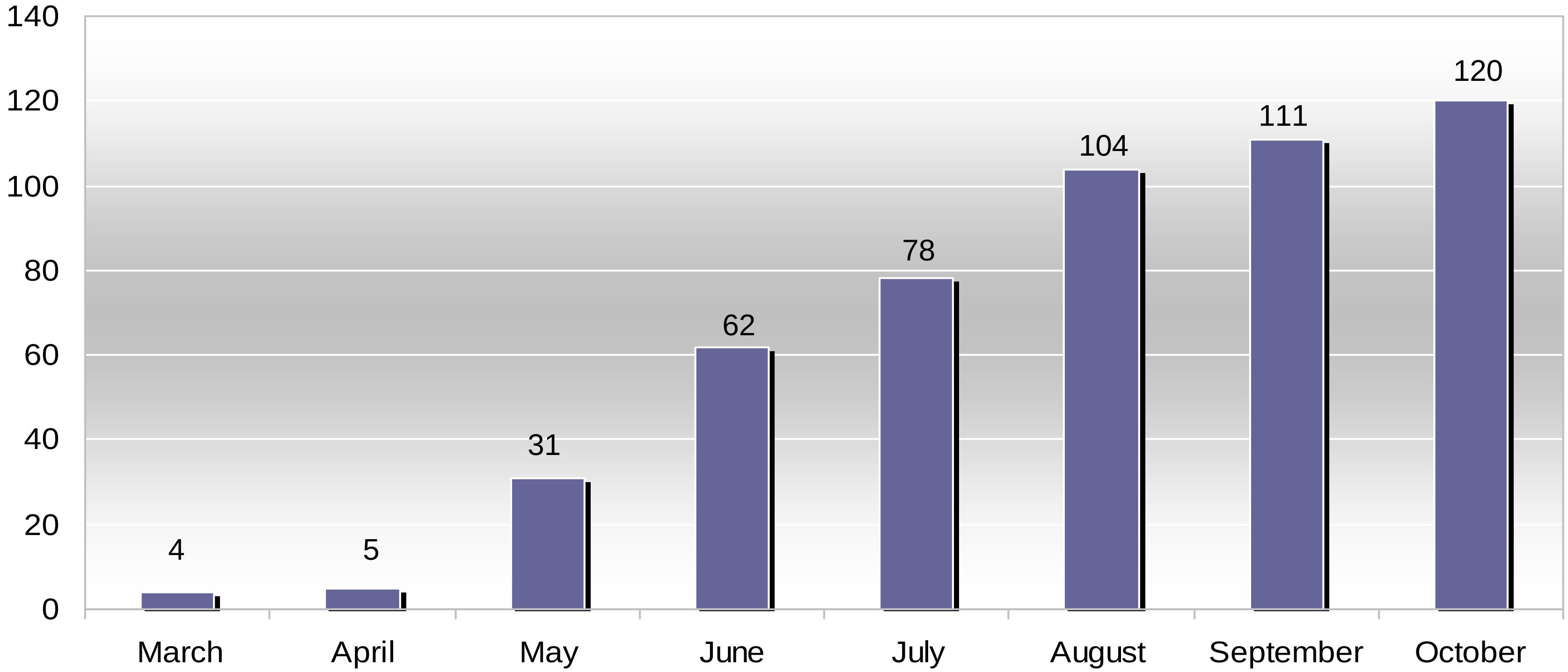
- Professor Lie's follow-up study finds evidence of option price manipulation at approx. 20% of public companies studied
- US Attorney's Office/FBI form joint Bay Area Stock Options Task Force
- SEC staff meets with Big 4 accounting firms to discuss backdating
- Public Company Accounting Oversight Board issues accounting guidance
- First indictments brought against former executives of Brocade Communications

September 2006

- SEC Chief Accountant, Conrad Hewitt, issues accounting guidance in letter to Financial Executives International and American Institute of Certified Public Accountants
- IRS joins the US Attorney's Office/FBI joint Bay Area Stock Options Task Force
- AFL-CIO asks large public accounting firms to explain role in option backdating and how practice was missed in audit process

The number of investigations *may* be leveling off

Approximate Number of Companies Under Investigation for Backdating in 2006



Source: Wall Street Journal

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A confusing new lexicon is evolving

Can also apply to dates of exercise, but not as common and not the focus

Term	Generally Accepted Definition
Backdating	Stated exercise price of a purported "at-the-money" option is lower than the actual market price of the stock on the date the option is approved/granted – as a result of ***intentionally*** manipulating the grant agreement to reflect a date in which the stock price was lower
Misdating	Same as backdating, but as a result of ***inadvertent*** use of the incorrect date for striking the option price (sloppy administration, incorrect procedures)
Spring-loading	Granting options shortly before the release of good news, securing a lower price and providing a quick option profit
Bullet-dodging	Delaying option grant until shortly after release of bad news, securing a lower price

In most cases, spring-loading used to cover bullet-dodging too

In general, the media refers to any of these issues as the "backdating scandal"

The list of infractions runs the gamut…

Least Egregious

- Picking monthly lows for new-hire grant groupings
- Poor Compensation Committee action documentation
- Poor grant execution/administration

Misdating

- Purposeful timing coincident with news releases

Spring-loading

- Picking low grant dates with disregard to procedure
- Forging grant documents

Backdating

Most Egregious

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Backdating is not illegal per se, if the following criteria are met

- No documents have been altered or forged
- Disclosed in clear and timely manner to shareholders
- Intent and direction of option grantor (Compensation Committee) followed
- Correctly reflected in accounting disclosures and charges
- Correctly taxed

How did this happen?

- An environment of “irrational exuberance”
- Pre-Sarbanes-Oxley controls (Form 4 two-day filing requirement… used to be up to 45 days for new grants)
- Auditor and internal accountant focus on other “hot topics” of the day (e.g., revenue recognition)
- Criminal or unethical behavior?

Current Guidance and Accounting Case Study

Recent Developments

- SEC letter dated September 19, 2006
  - From office of chief accountant
  - Staff guidance only, has not been approved by the commission
  - “We don’t get to enforce the accounting standards we wish existed; we have to enforce the accounting standards that do exist,” said Deputy Chief Accountant Scott Taub
- PCAOB Audit Practice Alert (APA) No. 1 dated July 27, 2006, “Matters Related to Timing and Accounting for Options Grants”
  - Auditors should be alert to the risk regarding accounting for stock options
  - Some feel this is “playing catch up”

SEC letter highlights

- The topics addressed largely relate to questions about measurement date
- Recognizes “unimportant delays” in the completion of administrative procedures may at times occur and would not result in an accounting consequence
- Absent clear information, the SEC will revert to patterns of past behavior

Measurement date definition

- APB 25 defines the measurement date as the first date on which, with *finality* (the SEC's new term), the following are established:
  - The number of options an employee is entitled to receive, and the option or purchase price
- Generally, the exercise price is intended to equal the market price on the measurement date and therefore no compensation expense is recognized

Question #1: Is this a backdated option?
(an easy one)

- Number of options (100,000), recipients and exercise price are approved by Compensation Committee on June 30
- The company stock is trading at $22/share on June 30
- Exercise price set as the price of the stock as of June 5, $20/share
- Company prepares documentation relating to award with an “as of date” of June 5

Answer #1

- The measurement date is June 30 since that is the date the number of options, recipients and exercise price are known with finality
- Compensation expense should be recorded

100,000 shares

x $2 per share benefit

$200,000

(expense would be amortized over option vesting period)

Question #2: Is this a backdated option?
(a little trickier)

- Oral authorization from Board given on June 30
- Written approvals are not received until July 31
- The number of options each individual will receive and the exercise price are known on June 30

Answer #2

- If awards were determined, with *finality* on June 30, AND
- There is no evidence that in some instances the company previously retracted awards or changed any terms of an award prior to completing all granting actions, THEN
- June 30 "measurement date" can occur prior to completion of remaining administrative steps

Question #3: Is this a backdated option? *(a tough one)*

- Board approved an aggregate 1,000,000 stock options to be granted to employees on December 5
- Although grant approved, management has the ability to allocate the options to individual employees as deemed appropriate
- The option price is set at $15/share, the market price on December 5
- Management completes the allocation of shares and begins communicating awards on December 29 to individual employees. On December 29, the stock price is $21/share

Answer #3

- The number of shares each individual will receive is not known with *finality* until December 29
- Measurement date is December 29 – the impact could be significant

1,000,000 shares
x $6 per share benefit
$6,000,000 impact

- If management were given no "flexibility"; there were definitive award amounts approved based on defined groups of employees within the organization, then the measurement date could be December 5

Other complexities to be considered

- Grants prior to commencement of employment
  - Measurement date cannot precede date individual begins rendering employee services
- Exercise price set as "lowest price over next 30 days"
  - Variable accounting until contingency is resolved
  - Once resolved measurement date could occur and variable accounting would cease
- Documentation is incomplete
  - Depends on particular facts and circumstances
  - Does not result in a "negative default"
  - Past pattern is important to consider

Case study – backdated option accounting assumptions

Shares Outstanding	200 million
Annual Options Granted	10 million (5%)
Vesting Period	4 years
Average Benefit of Backdating (1999 – 2002)	$1/share
FAS 123(R) Status	Not adopted until mandatory (2006)

Case study – backdated option accounting outcome

- Restates financial statements in accordance with APB 25 – impacts 1999-2005

	Accounting Charges That Should Have Been Recognized ($Millions)						
Annual Grants	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
1999 (10M options)	$2.5	$2.5	$2.5	$2.5			
2000 (10M options)		$2.5	$2.5	$2.5	$2.5		
2001 (10M options)			$2.5	$2.5	$2.5	$2.5	
2002 (10M options)				$2.5	$2.5	$2.5	$2.5
Total	**$2.5**	**$5.0**	**$7.5**	**$10.0**	**$7.5**	**$5.0**	**$2.5**
Per Share Impact	**($0.013)**	**($0.025)**	**($0.038)**	**($0.050)**	**($0.038)**	**($0.025)**	**($0.013)**

….with the greatest impact during the worst stretch of the market downturn!

Collateral Damage

If guilty of pricing stock options below correct FMV, multiple perils emerge

- Accounting charges
  - Illustrated in case study example
  - P&L impact under historic APB25
  - Havoc on past FAS 123 valuations and footnote disclosures – impacting recent FAS 123(R) transitions (modified retrospective application, APIC pool calcs)

Multiple perils ... (cont.)

- Income taxes
  - No longer performance-based under 162(m)
    - Affects named executive officers only
    - Loss of deduction above $1M cap
  - Subject to 409A
    - Discounted options are non-qualified deferred comp
    - If vest after December 2004, subject to ordinary income, 20% penalty and interest charges
  - Disqualification of Incentive Stock Option (ISO) status
  - Withholding errors

Incorrect accounting for these tax implications can be material in themselves, helping to trigger restatements

Multiple perils … (cont.)

- Civil lawsuit exposure
  - Investors
    - Breach of fiduciary responsibility, waste, misconduct
    - Sarbanes-Oxley
- Employees
  - Recovery of 409A back taxes and penalties, if applicable
- Customers
  - Satisfaction of current contracts in jeopardy due to distractions
- Credit rating downgrades

Multiple perils … (cont.)

- Criminal indictments
  - Brocade and Comverse first two indictments
  - Of the 120+ investigations currently underway, criminal indictments likely to be relatively rare
- Sarbanes-Oxley
  - Disgorgement of all incentive (bonus and equity) profits from the CEO and CFO due to restatements
- Employment law
  - Deep discount options (>15%) is part of overtime for hourly-overtime eligible employees

Multiple perils ... (cont.)

- Other collateral damage
  - Delayed filings of 10-Q and 10Ks
    - Delisting from the NASDAQ or NYSE due to delayed filings
    - Loss of S-8 registration for all equity plans, if financial restatements are delayed significantly
    - Non-compliance with indenture covenants (and forced debt settlement along with stiff fees)
  - International accounting impact (parallels US), triggering US-like multi-disciplinary fallout
  - Stock price hit = takeover target
  - Employee attraction and retention challenges
  - Distractions and instability caused by leadership turnover
  - Public relations challenges
  - Outside attorney and auditor liability for allowing backdated options to pass audit muster and end up in SEC filings
  - Personal exposure for corporate Officers and outside Directors when terms of D&O insurance do not cover acts of misconduct related to stock compensation or other actions associated with backdating

Remedies

Remedies fall into two categories

Remedy Type	Description	Issues Addressed
Preventative	Go-forward changes to policies and practices meant to mitigate the potential for future infractions	• Sloppy administration • Poor communication/processes • Knowledge/training shortcomings • Ethical shortcomings
Restorative	Actions and programs meant to identify and rectify existing infractions	• Internal option grant audits • Public relations planning • Financial restatements • Employee communications • Backdated option exchange offers

Preventative remedies/CD&A disclosure

- Timing and exercise price of stock options
  - If the Company has a program, plan or practice to time stock option grants to executives in coordination with the release of material non-public information (the "preamble" questions), the CD&A is also to address the following questions:
    - Does the Company have any program, plan or practice to time grants to executives in coordination with the release of material non-public information?
    - How does any program, plan or practice to time grants to executives fit in the context of any program, plan or practice with regard to employees more generally?
    - What was the role of the Compensation Committee in approving and administering a program, plan or practice to time grants?

Preventative remedies/CD&A disclosure (cont.)

- Timing and exercise price of stock options (cont.)
  - How did the Board or Compensation Committee take such timing information into account when determining whether and in what amounts to make grants?
  - Did the Compensation Committee delegate any aspect of the actual administration of a program, plan or practice to any other persons?
  - What was the role of executive officers in the Company's plan, program or practice of option timing?
  - Is the grant date new executives options set in coordination with the release of material non-public information?
  - Does the Company plan to time, or has it timed, its release of material non-public information for the purpose of affecting the value of executive compensation?

Preventative remedies/CD&A disclosure (cont.)

- Discussion of the determination of the stock option exercise price in the CD&A will be required in the following circumstances (the "materiality" examples):
  - The exercise price is based on the stock's price on a date other than the actual grant date
  - The exercise price is determined by using a formula based on average prices of the Company's stock in a period preceding, surrounding or following the grant date
  - The exercise price is determined by a formula based on lowest prices of the Company's stock in a period preceding, surrounding or following the grant date

Preventative remedies/proxy table

Grants of Plan-Based Awards

Name	Grant Date	Estimated Future Payouts Under Non-Equity Incentive Plan Awards			Estimated Future Payouts Under Equity Incentive Plan Awards			All Other Stock Awards: Number of Shares of Stock or Units (#)	All Other Option Awards: Number of Securities Underlying Options (#)	Exercise or Base Price of Option Awards ($/Sh)
		Threshold ($)	Target ($)	Maximum ($)	Threshold (#)	Target (#)	Maximum (#)			
(a)	(b)[1]	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)[2]
PEO										
PFO										
A										
B										
C										

[1] If the grant date is different than the date action was taken by the Compensation Committee, Board of Directors or other committee, a separate column showing the other date must be added between columns (b) and (c)

[2] If the exercise price is less than the closing price of the Company's stock on the grant date, a separate column showing the closing price must be added after column (k)

Preventative remedies/option pricing best practices

Issue	Description
Amend new-hire grant policy to avoid grouping and picking period lows	• Execute new-hire grants by group on the same set day (e.g., 15th of every month following start date, or last trading day of quarter)
Avoid price timing when issuing performance grants during black-out windows or when material non-public information is known (e.g., near quarter end)	• Establish regular grant ***windows*** for ongoing awards outside of 401(k) and other blackout dates
Grant options approved by written consent of the Compensation Committee	• Establish a formal process for gaining approval if using written consents or only approve grants at Compensation Committee meetings (including via phone) where minutes can document actions taken including setting price and vesting schedule
Minimize or eliminate delegation of grant authority from the Compensation Committee to management with a committee of one (e.g., CEO)	• Provide formal process and approval rights to Management that are audited quarterly by the Compensation Committee • Committee should include cross-functional members including minutes from meetings for auditing

Preventative remedies/other actions

- Conduct briefings and training on backdating issues
  - Board plus Compensation & Audit Committees
  - Executive team
  - HR business partners/stock administrators
  - Hiring and people managers

Restorative remedies

- External Communications
  - On own terms
  - Proactively, not reactively
- Investigative activities
  - Board, Audit or special Committees undertake a review of past activities
  - Impartial review of records, interviews with relevant associates
  - Should involve outside counsel and 3rd party independent investigators
- Coordinated defense strategies
  - Multidisciplinary response is needed
  - Accounting response must not undermine a civil suit defense or D&O coverage

Restorative remedies (cont.)

- Option valuation/financial statement restatements
  - Revalue options with new information and assumptions
  - Restate financial statements, SEC filings, disclosures as required
- Communicate to employees
  - What the issue is and why the company is in the news
  - What steps the company is taking
  - How this affects the employee
  - How to handle customer questions
- Communicate to customers
  - What the issue is and why the company is in the news
  - What steps the company is taking
  - How this affects their service

Restorative remedies (cont.)

Strategy	Description	Pros	Cons
Offer to Cancel*	Employees voluntarily cancel backdated options for a cash payment	• May not require shareholder approval *(subject to legal interpretation of company plan and NASDAQ/NYSE rules)*	• Cash outlay • No retention provided • Shares may not return to pool available for future grant *(subject to legal interpretation of company plan and NASDAQ/NYSE rules)* • Requires SEC tender offer
Offer to Exchange*	Employees voluntarily cancel backdated options for new equity awards (options or restricted stock)	• Maintains employee stock ownership levels • Can provide additional retention through new stock vesting • Unused shares likely to return to pool available for future grant • No cash outlay	• Requires shareholder approval in most cases *(subject to legal interpretation of company plan and NASDAQ/NYSE rules)* • Requires SEC tender offer

**Note that offers to cancel or exchange existing awards have to be treated as voluntary tender offers under SEC rules. These tender offers require substantial disclosure through special SEC filings and must provide the option holder 20 business days to elect to participate.*

Restorative remedies (cont.)

Strategy	Description	Pros	Cons
Offer to Amend Option Price*	Employees voluntarily amend options to increase strike price to the actual FMV on the original date of grant in return for a cash payment	• May not require shareholder approval *(subject to legal interpretation of company plan and NASDAQ/NYSE rules)* • Maintains employee stock ownership levels	• Cash outlay • No additional retention provided • Requires SEC tender offer
Election to Lock in Future Exercise Price	Elect a fixed future exercise date of backdated options	• May avoid future 409A tax penalties (***must be done in 2006 for officers & directors***) • No cost to company • Does not require shareholder approval, nor an SEC tender offer	• Eliminates employee ability to time optimal exercise – potential to exercise underwater options if stock is volatile • No additional retention provided

**Note that offers to cancel or exchange existing awards have to be treated as voluntary tender offers under SEC rules. These tender offers require substantial disclosure through special SEC filings and must provide the option holder 20 business days to elect to participate.*

D&O Insurance Considerations

D&O coverage questions include:

- Can notice of claim or circumstance be effected under current policy?
- Can Extended Reporting Periods be leveraged?
- Will insurers seek “option issuance practices” warranties going forward?
- Are insurers able to look back to previous applications and public filings to determine misrepresentation?

D&O coverage questions include:

- What is the impact of misrepresentations?
  - Severability of application / representations vs. imputation?
  - Presumption of materiality?
  - Impact of Financial Restatements - Rescission potential?

- Can insurers invoke personal conduct/ intentional acts exclusions?
  - Fraud / Illegal Profit?
  - Short-swing (16b) Exclusion?
  - Trigger language – who decides when exclusion applies?
  - Exclusion severability – who may lose coverage?

Strategies to Manage Options-Based D&O Exposure

- Claim vs. Circumstance – determine if current-term notice advisable or appropriate
- Consider Extended Reporting provisions as leverage in D&O renewal strategy and proceedings
- Faithful disclosure in renewal context
  - Burden on insurers to ask the “right” questions of the appropriate company representatives
- Avoid warranty requirement or mitigate warranty impact through effective strategy

Secure effective D&O coverage on a go-forward basis by prioritizing

- Scope of Application (limit)
- Representations/ Application Severability
  - Limit scope of imputation
  - Avoid presumption of materiality
  - Minimize rescission potential – use of affirmative language
- Personal Conduct/ Intentional Act Exclusions:
  - “Deliberate”
  - “Final Adjudication” trigger – without additional qualifiers
  - Avoid exclusionary language wrapping in any negligence standards
  - Avoid / amend 16b Exclusions – defense cost implications
- Other / Policy Specific

Questions?

Thank You!

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