Webcast: Backdating Stock Options
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Presented by ACC's Litigation Committee, sponsored by CRA International, Inc. and Winston & Strawn LLP
Presenters: Seth Aronson, O'Melveny & Myers LLP, Brad Cornell, CRA International, Inc., Christine Edwards, Winston & Strawn LLP and Gail Standish, Winston & Strawn LLP

Moderator: Jonathan Yellin, General Counsel, CRA International, Inc.

ASSOCIATION OF CORPORATE COUNSEL

Moderator: Jonathan Yellin
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Operator: Just a reminder, today's conference is being recorded.

Female: Please begin Jonathan.

Jonathan Yellin: Good afternoon. My name is Jonathan Yellin and I'm General Counsel for CRA International and on behalf of CRA and Winston & Strawn, I want to thank everybody for participating in today's ACC event, Backdating Stock Options.

We have four outstanding speakers and I'm sure, as all of you have seen in today's Wall Street Journal, the Senate, the SEC and the DOJ are putting this issue on the top of their priority list.

Today's speakers are Seth Aronson. He's head of O'Melveney & Myers Los Angeles office and he's Chair of the Securities Litigation practice and a member of the firm's Joint Leadership Team. He defends corporations, directors, professionals and securities class actions, shareholder of derivative suits and other litigation matters.

We have Dr. Brad Cornell, who's a Senior Consultant with CRA International, also a visiting Professor of Financial Economics at the California Institute of Technology. Dr. Cornell is a recognized authority in the application of financial economics to business litigation and regulations.

We also have Gail Standish, a Partner, Litigation Partner at Winston & Strawn's Los Angeles office. She concentrates on a practice in securities and intellectual property matters.

And finally, we have a Partner, Chris Edwards, from Winston & Strawn. Chris is a Partner with Winston & Strawn Corporate Practice group. She focuses on regulation of financial services industry, particularly in the securities and banking industries, as well as corporate governance, public and regulatory policy issues.

First, we're going to have Seth talk about general background including events (preceding) the backdating issue, basic terminology in some of the firms who are being investigation. Brad Cornell will talk about the underlying economics and damage issues.

Gail will address what in-house counsel needs to know and what to expect when the SEC or DOJ want to look at the books and records and files of the company. And Chris will talk

about what in-house counsel should be doing to prepare for what will be certain questions from senior management, board and directors.

And with that, I'm going to turn it over to Seth.

Seth Aronson: Thank you Jonathan and welcome everyone. We've looked forward to an exciting program. Anyone who has not heard about the backdating stock options issue has probably been on another planet for the last several months because this really is the hot topic.

It is in all of the newspapers, the business press, the legal press, front page news and has affected a number of companies throughout the U.S. Now where did all of this begin? Well, it began somewhat with Professor Eric Lee at the University of Iowa, who in May of 2005 published his findings by looking at nearly 6,000 stock options granted to CEOs during 1999 – I'm sorry, 1992 through 2002.

And he founded abnormally low returns before grant dates, the stock prices before grant dates were at very low prices, and he concluded from that that unless the executives had some sort of ESP or ability to predict the future, that there was some indication that these awards were timed retroactively.

Now, we'll get into what that means in a moment, but this is when it began, in May of 2005, but really didn't take hold until a little while later. In the fall of 2005, the Wall Street Journal reported on this issue very briefly. Again, that article did not get too much traction, but what got everyone's attention was the March 18, 2006 Wall Street Journal, “The Perfect Payday”, and it looked into stock option probabilities on a much larger scale.

This is what really hit the press on May 18, and it mentioned a number of cases as well. The full title of the article was, "The Perfect Payday, Some CEOs Reap Millions by Landing Stock Options when they are most Valuable, Luck or Something Else." Well, that is what we're looking at now. Was this luck or was it something else?

There were some examples that were given in that Wall Street Journal article and in one instance, they said that according to their analysis, that the odds of this happening by chance, at random with the CEOs being able to achieve the rise in stock price following a steep decline to be 300 billion to one. It gave an example of one company there.

Now, where are we in the current environment? Well, Professor Lee has been joined by Professor Randall Heron of Indiana U. and they've looked into this now of 40,000 stock option grants to top executives between January 1, 1996 and the end of 2005. Their findings are that more than 13 percent of these grants were backdated or manipulated.

Before August 29, 2002, which was the effective date of Sarbanes-Oxley, which directly affected the reporting for stock options, it noted that 23 percent of unscheduled (at the) money grants were backdated and that almost 30 percent of the nearly 8,000 firms manipulated their grants to top executives at some point during the time period that they were looking at, the 10-year time period.

Now, we've used some terms here and it's important as we go forward in today's presentation to know what some of the basic terms are. And we've given you four of them.

The first is backdating. What backdating has come to mean is someone going back in time to create a grant date where the stock was trading below the actual grant date.

Let me give you an example. If on day one, stock options are granted to an individual, that should be the date that measures the value of the stock option on that day. If someone turns back the clock and goes back before that day one, 10 days earlier to look back and see that the stock was trading below that grant price and goes back and changes the grant date, this is going back in time and this is something that is clearly illegal.

Then there's misdating stock options and that's honest, but sloppy paperwork and let me give you an example of that. Oftentimes the compensation committee will grant stock options effective a certain date, let's say that's day one.

And that the stock options become effective when the board approves the compensation committee's recommendation. This all of course depends upon each particular company's stock option plan. But if it takes some time to get the written consents from all of the directors, it could take a while. It may not happen on day one.

It may not happen on day two. By the time the last unanimous written consent comes around, it might be 30 days down the road. What is the effective date of that stock option grant? Is it day one or day 30? But that's misdating and that's honest, but sloppy paperwork, and quite frankly, I think that that will be what most of the companies looking into their stock option grants are going to find.

That is, they will not find intentional fraud for the most part, but rather some sloppy paperwork. Then there are two other terms that have come into the lexicon.

One is known as spring loading and that is when senior management or the compensation committee sets a grant date while they know that the company will disclose some material non-public information that will drive the stock price up.

They know there is going to be some good news. They know that they're going to strike oil or they're going to announce that, and they issue the stock option grant on day one, knowing that on day 20 or day 30, good news will come up and that stock price will go up. A very controversial topic as to whether or not this is legal or illegal.

We have at least one SEC commissioner who has said that it is not illegal. Finally, and perhaps the most difficult to prove, is what's known as bullet dodging. And that's the exact opposite of spring loading; that is, delaying the grant date when you know that the stock price will likely go down.

So if you grant the stock options on day one, but know that the company will disclose some material adverse non-public information say on day 10, you go ahead and delay the grant date until day 10 when that stock price is down. So those are some of the basic terminologies that we've used.

And here is a partial list of the companies that have come under scrutiny, so you can see although they are primarily in tech companies, because after all, during the tech boom of the

1990's, the currency for luring top executives was stock options, especially with companies that did not have a record of high earnings.

But it has also reached out beyond the tech industry and has covered industries throughout ((inaudible)).

So with that, I will now turn this over to Brad Cornell, who will take it from here. Brad?

Brad Cornell: Thank you Seth. If you'd look at my first chart please, you'll see some background that I think is useful in understanding some of the issues that make this such an emotional debate.

What I'm showing here is the total compensation of major CEOs from 1970 through 2002, and you can see here in the early '90s, there is a very dramatic ramp up, and part of that is explained by the fact that in 1993, Congress passed a law that made income above $1 million taxable unless it was special incentive compensation.

And options counted as special incentive compensation, so it made options a particularly attractive form of compensation. But given the size of this ramp up, there was a very extensive debate in the academic literature about why compensation had risen so rapidly whereas it hadn't in the past. And there were two hypotheses.

One was that it was increased competition for top talent and the other was it was the ability of CEOs and other top executives to capture the board and really improve their own position at the expense of shareholders.

And the reason I give you this background is I think that that compensation debate underlies much of this and I think we're going to see Congress and the SEC and others become concerned that shareholders were taken advantage of in the option backdating given that it can't be an incentive is at the core of that.

And I think that's going to become a focal point of the legal and regulatory debate. Now, to tell you just a little bit about the academic work that led to this dispute, an implication of the efficient market hypotheses which is used widely, for example in securities litigation, is that stock prices should not be predictable.

Other than a normal return on the order of 10 percent, you shouldn't be able to say whether any particular company was going to do better or worse than that normal amount.

And one of the things that scholars spend a lot of time studying is seeing if certain bits of information can allow you to predict stock prices and stock returns more accurately than that. And in 1997, (John Nuremark) of NYU published a paper where he found that the granting of stock options seemed to allow such predictability.

He did not find a great deal of predictability, but he did find some and he attributed it to the fact that companies may be granting stock options when they thought their future prospects were very bright. But Eric Lee picked up on this idea, updated it, used a much more expensive sample, and got the following picture.

And here in Lee's picture, you can see this is the grant date. But prior to the grant date, there were sharp declines in stock prices and following the grant date, there were sharp increases, and this was entirely inconsistent with the efficient market hypotheses. In fact, this predictability extended not only to the individual company, but to the market generally.

And Lee thought that was only explainable if in fact the companies had backdated the options where they knew that prices were low and that's the only way that he could rationalize such an extensive predictability. Now on a follow-up (test) on that, Lee noted that before 2002, stock option grants were reported ((inaudible)) actually see using four and five, which wasn't due until 45 days after the company's fiscal year end.

This allowed for great latitude in potential backdating. Following Sarbanes-Oxley in August of 2002, stock option grants must be reported to the SEC within two business days of the grant date, greatly limiting the latitude for backdating. And this is seen immediately when we turn to the follow-up research by Lee and (Heron).

Here, we see the pre-Sarbanes-Oxley picture where there are dramatic decreases in stock prices prior to the grant and increases after, indicating that the grant was picked to be backdated to a point where stock prices were low. Up here we see the post Sarbanes-Oxley results and the backdating pattern is largely, if not exclusively, eliminated.

Now, to illustrate just exactly how this works and say a few words about this, here's a ((inaudible)) example. The actual grant date of the action is here on day 20 when the stock price is $50 per share. But the grant date is backdated to a point when the stock price was at its minimum of $40 per share.

Now, what this means is on the day that the executive actually receives the option, the action is going to be in the money because it will have a stock price of 40 from the backdate, but the current market stock price would be $50, and that means on the day that it is granted, the option will have a good deal more value than it appears because of the artificially selected backdated exercise price.

And using standard option pricing models such as the ((inaudible)) model, we can compute how important this backdating effect might be, and here's an example. Following up from the previous chart, it shows a one-year option that is both granted at the money at $50 per share and backdated one year - a backdated one-year option with an exercise price of 40.

And the bottom line is without the backdating, if the option had been granted at the market in this particular calculation with 500,000 shares worth of options, the grant is worth 3.1 million. However, if it's backdated so that the option is in the money effectively at the time of its grant, it's worth $6.3 million, about 100 percent difference.

And we know here that the difference, at least in percentage terms, is very sensitive to the maturity of the option, so in computing the added wealth transfer to executives by the backdating of options, it's critical to have all the terms of those actions.

Now the critical point in my opinion that companies are going to face is what is the damage caused if it is found that a company has backdated its options? And from a direct point of view, the only (cost) would be the added compensation that executives received that the market did not believe at the time that they were going to get.

So if I return here to a previous slide and use the one-year option, if investors believe that the grant was at the money, they would calculate that the executive was receiving $3.1 million. If in fact it had been backdated, then effectively he'd been granted $6.3 million.

However, when we talk about major companies, the number of dollars involved in the direct (cost) of backdating is going to be relatively small. That doesn't necessarily mean that plaintiffs, either in securities or derivatives, will only ask for small numbers and there are several reasons for that.

The first is the stock price drop on revelation of backdating might be much greater, in fact, frequently is likely to be much greater than the direct cost of backdating itself, and there are a number of reasons for that. The first and perhaps most important is that companies that backdated will almost invariably have to restate their prior earnings.

This is because when options are granted at the money, during the period of time prior to 2002, they don't have to be expensed, but to the extent that options were granted in the money, the amount by which they were in the money does have to be expensed.

Therefore, companies will have to go back and restate to take that out and if these are technology companies, trading at very high multiples of earnings, it's possible that a relatively modest change in earnings could lead to a substantial change in valuation.

There may be also tax effects associated with readjusting the earnings because to the extent that the options are in the money, added taxes are typically due. Companies also face the

cost of investigating the backdating, finding out the role of the board, what the board knew, whether the board was independent.

These investigations can be extensive and expensive. There is an issue of management credibility, what type of management would engage in this activity, and perhaps most importantly, should the management that engaged in this activity continue to be retained? If it's not, there may be a costly shakeup and search looking for a new CEO and so forth.

And all that would lead to substantial potential damages beyond the cost of direct compensation. So these are the type of economic issues that I believe that firms are going to have to address.

And with that, I'd like to turn this over to Gail Standish.

Gail Standish: Thank you Brad and I'm going to go ahead here. Brad and Seth talked a little bit about the background and then Brad just got into the potential ramifications on the real economic side. What kind of legal ramifications are companies actually facing out there now?

And I want to start by talking about the investigations, the government investigations that have been the topic of a lot of media and the testimony, as a matter of fact, yesterday that was – that was given in part by Commissioner Carr of the SEC.

The SEC and DOJ are both hot on this issue now, and one of the things that corporate counsel need to remember is that if there is an SEC or DOJ investigation, and you get a

subpoena or even just a letter of interest, that this is an adversary proceeding, but it is not the typical adversary proceeding that most counsel are used to dealing with in a litigation.

There are a lot more issues to deal with in that it is at the same time a cooperative investigation, if you want the company to come out looking like it is a good corporate citizen, even if it did actually have real backdating issues as opposed to some of these misstating issues that Seth was talking about.

So knowing that the government has resources behind it, but have some very specific goals is important, and some of those goals that are different than like a plaintiff side, shareholder litigation, are that while they are out to get the wrongdoers, they really actually don't want to harm the company because harming the company again is harming the shareholders to another degree, to an nth degree.

But there's almost no way to avoid that because while you're dealing with a government investigation, you have the plaintiff's lawyers licking their lips on the side. So getting to what's actually going on out there, document requests may come from multiple organizations at the same time, the SEC, the DOJ, the Department of Labor, and the documents that can be requested could be very, very broad.

And they are the same kind of documents that you're going to want to look at even in advance of any investigation to see if the company has some kind of problem. The investigation can get very expensive because the agency may request interviews of officers and directors and even down to line employees.

And so again, the interesting issues that come up there are that if you are not actually representing the line employee, you may actually be excluded from the interview by the SEC or the DOJ. It's not your normal adversary proceeding. Most companies want to immediately and fully cooperate.

One of the things to keep in mind there is that it's very difficult in today's climate to protect the attorney/client privilege. If you've done a self investigation, that self investigation is likely going to be voluntarily turned over to the SEC or the DOJ.

And in that instance, there are very few jurisdictions left in the United States where you're going to be able to protect that from plaintiff's lawyers, you know, in a future suit.

Now, to date, the actions as I was talking about, if they've targeted individuals, not the companies, and I won't talk too specifically about these, but everybody has probably read about the Brocade case and the (Converse) case. And you know, the reason again that the government is going after the individual wrongdoers is (a) it's much easier to prove.

In these cases, these particular cases, there are paper trails showing actual forgery of documents and dates, actual backdating in the sense that Seth had explained where somebody actually sits there with a piece of paper, picks a date and then predates perhaps a unanimous consent or something, making the date of that option an earlier date than the actual grant date.

But nevertheless, of course, the company has to deal with the fact that it may now be adverse to its own employees or former employees, and at the same time, have to indemnify

them. So you know, want in a sense to serve up their heads on a platter if that is indeed the right thing to do with the government, and yet protect the company from its responsibilities based on those actions.

And so the SEC has made very clear that it's not trying to further harm the shareholders by devaluating the company, but that's nevertheless going to be a problem that the company is going to have to face. Now, the next couple of slides I'll just go through quickly.

These are just sort of the actual causes of action that have been listed in either the indictments by the DOJ or the complaints by the SEC. The DOJ actions, some of what gets charged really depends on which agency or agencies are investigating a lot of these are FBI, but you'll also find that IRS criminal investigation division folks get involved and then they'll be more focused on tax consequences.

Some of the indictments are going to contain all of these types of claims, causes of action and will probably be superseded several times over the course of the – to the continuing investigation after indictment. With the SEC, primarily it's going to be misleading the market, but there are also again all of the other tax implications and everything can be folded into an SEC complaint as well.

Again, penalties, they're against individuals at this point. So far, they haven't asked companies to cough up big fines and I don't think they will, but you know, query, whether or not there's going to be some way for a company in dealing with its executives to have some kind of consent decree with the SEC that involves the executives paying for a fine that doesn't wind up in some way redounding on the company itself.

Now, here's where the in-house counsel are probably used to dealing with some of the issues as Brad suggested.

The stock price drops that may occur on announcement of bad news, which may primarily be due to lack of investor confidence and not really related specifically to what was allegedly concealed from the market, a small amount or relatively small amount of compensation that was not recorded, which is really what the issue is here, is executive compensation that was not reported to the market or to the SEC.

If that causes a stock price drop, you're going to get a securities fraud class action suit and the class periods, there have been several filed, although they are not as common yet as the breach of fiduciary duty suits we'll talk about, that typically have class periods that go through 2002 because of course, that's that magic stocks date that both Seth and Brad talked about where the reporting requirements for the options backdating changed.

However, some of them go through the present and as you'll see, if you look at some of those complaints, it's whatever day the company may have announced its self investigation.

And the causes of action are the typical securities fraud causes of action which are violations of Rule 10B5, Section 20A is their control person liability provision wherein the plaintiff's lawyers would try to sweep in all of the board members, officers and directors that they possibly can, even those who did not – are not responsible technically for making a statement to the market or that had no duty to speak.

And the relief sought damages generally which may be very difficult in a sense for the plaintiffs to prove their damages theories, are going to try to capture that entire stock price drop.

But as Brad was talking about, how much of that stock price drop is really just a general loss of confidence in the company and how much of it can actually be tied back to the alleged misrepresentation, which is a concealment of the fact that compensation was being given illegally in a sense to the executives?

Now, what's more common today are shareholder derivative suits because liability is going to be much easier to establish, as will some measure of damages although how the plaintiff's bar is going to make these into large measures of damages is yet to be seen.

You know, one thing that corporate counsel should keep in mind is that they may actually get – some companies are actually getting demands from their shareholders that they take action. That's actually rare because usually the plaintiff's law firms want to go in and say that the demand that they're required to make on the board is excused because the board is interested in the transaction and incapable of evaluating whether or not to sue itself essentially. And so that's the first hurdle that these cases have to go over.

In many derivative suits, that's a winning argument for in-house counsel. That's less likely to be a winning argument in these cases because so many of the executives either benefited from the backdating or were in fact members of the compensation committee. So these cases are more likely I think to go forward, you know, beyond the pleading stage.

The other thing to remember about derivative suits versus the securities fraud suits is that they are the type of case where it is a race to the courthouse, but just because somebody won the race to the courthouse doesn't mean that they stopped being filed.

Some of the companies that were sued many months ago, you see new derivative suits pop up all the time, and what unfortunately happens is the company becomes a battleground among the plaintiff's lawyers for who is the one that's going to be lead lawyer, lead plaintiff and get money from the company.

Here are the typical causes of action you see, the breach of fiduciary duty, of loyalty and care, and then just the others that are – that are listed. It's usually a kitchen sink type of complaint.

And again, the easy measure of damages is, well gee, you've damaged the company by how much extra compensation you gave that somehow should have been in the company's bottom line as opposed to in the executive's pocket, but as Brad mentioned, that's not where the real money is.

The real money is going to be tying the whole scheme back to the value of the company being damaged by the mismanagement essentially, and so it's going to be a very – this is going to be a very hot topic. It's going to be interesting to see how many of these cases go beyond relatively quick settlements because people are going to be afraid of very large jury verdicts because it is such a hot issue today, the whole issue of executive compensation.

And then the other thing is, who's paying for all of this? Not only the investigations and perhaps the payouts, but the defense of the individuals who may have been involved in illegal activity? And there have been some, you know, recent articles on D&O policies and what they cover.

They may cover a lot of this, although now they're, you know, writing them with exclusions based on the options really to claims, but there are more issues that arise because your defense strategy in an individual case may conflict with your strategy for obtaining the most coverage out of your insurance.

And so you need very early on to have somebody who has their brain around all of the issues, including the government investigation, if there is one, early on to decide what's the best course to take in the ((inaudible)) for all of these causes of action.

You know, one of the things that's interesting is that the policies don't cover most of the time the investigation done by the DOJ or the SEC, which can be the most expensive in terms of discovery, but at the same time, there is one of these derivative or fraud suits going on, then usually you can negotiate with the coverage – with the insurance carrier as to what percentage of those costs they may or may not pay.

So another – just another thing – another ball to try to keep your eye on. And with that, assuming that I'm technically savvy enough, I'm going to turn then over to my partner, Christine Edwards from our Chicago office.

Christine Edwards: Thanks Gail. Well, in thinking about what it is that you've heard thus far in the presentations, you've heard a lot about, you know, what precipitated this series of inquiries into companies' practices with respect to equity grants to their executive officers, their board members and their employees.

You've also heard a lot about the economics behind what is driving the analysis here and I might suggest that really this issue, the stock option backdating issue is simply the latest iteration in the focus on what the media has characterized as out of control executive compensation.

And I think what Gail has very importantly set forth are what are the causes of action that are being brought here? What are the companies' practices that will come under scrutiny and what legal theories will be used?

So I think for a corporate counsel, once you have a good sense of the risks and what the potential liabilities are in these issues, you very quickly begin to consider, what can you do about this?

So first, I think we need to recognize that we are in an environment of extremely close scrutiny created by these stock option backdating problems and while at the outset of the media regarding these companies, the corporate counsel that I was dealing with believe that it was a contained problem to particular types of companies.

We have now seen that this really is much broader scrutiny on issues relating to equity award grants generally. So they found, you know, what are the legal theories around

criminal cases, around civil cases, the fact that there are regulatory implications with the commission? And (Sherman Cox), as Gail said, testified yesterday.

He talked a lot about working in tandem with the PCAOB and as you know, in July of this year, the PCAOB issued their first ever staff audit alert, which addresses stock option issues. And basically, it reminds auditors of their duties to report illegal acts, and second, it talks about the impact of option issues on auditor's opinions in annual reports and registration statements.

And of course, in addition to all of the environment that I've just mentioned, we are under close scrutiny as corporate counsel for the media. There are lots of articles being written every day about companies that have filed recent SEC filings indicating that they are reviewing their practices.

In addition to understanding the external environment, we are in September of the year, and of course, we understand that the board and corporate calendar implications play into a close scrutiny of this area, because we are looking now at year end evaluation issues, our compensation processes will begin very shortly, and boards of directors will be very, very focused on this.

In addition to that, we have new SEC executive comp rules that are going to change the way that the proxy reporting for executive compensation takes place and the new CD&A which is a companion now to the MD&A, will likely require the same type of reporting of certifications that are required for the finance organizations of your companies.

And so your procedures and safeguards are going to be coming under great scrutiny because of this, you know, sort of perfect storm environment.

As I had mentioned before, the board and compensation committee meetings are scheduled for the third and fourth quarters, you can anticipate that questions are going to be asked regarding what is our exposure and what are our procedures with respect to not only stock option grants, but our equity compensation procedures more generally.

And a question that counsel should be thinking of now is, is it likely that your board or a member of your board is going to suggest that the company issue a comfort letter or a statement that no problems exist within our company, because that comes – that brings with it an additional measure of concern around the process of looking at your practices.

If you're going to look at your practice, consider the privileged nature of the inquiry that you want to make and if you want to have a privileged inquiry and a review of your practices. And you also want to determine that if at the end of your review of your practices, whether you want a privileged response, that is, an attorney/client privilege memorandum to executive officers, to your chairman and CEO, to your board of directors.

You want to think about that prior to commencing your review. And if outside counsel should be retained, consider the counsel that you retain as part of this process because there have been a number of articles talking about whether it is wise to engage outside counsel that has ordinarily advised the company on their compensation programs and equity option plans as opposed to a more independent outside counsel.

And also finally consider that what we all consider to be best practices for equity compensation awards, definitely is changing because of these ongoing investigations, and the level of scrutiny on our practices will change accordingly. So three steps real quickly, what can you do?

Review company policies and procedures, investigate historical practices, and step three, take corrective action. Let me talk a little bit about each of those. In step number one, to the extent that you determine that you want to review these areas, the beginning point should be the company's by-laws and equity award plans.

You want to determine what those plans provide for purposes of the process for granting of equity awards. Is there permission within the context of those plans to issue in the money options? And who has authority in essence to grant those stock options? Is it the entirety of the board of directors?

Has it been delegated to the compensation committee with an approval process thereafter with recommendations from the comp committee by the board of directors? Or is the practice really delegated to an executive officer? When can options be granted?

If there are certain time periods specified and there are different employment cycles within your company, you want to take a look at instances where there are differences in that specified time period. Those may result from hiring.

It may result from promotions and it may result from modifying the underlying plan to specify a different timeframe for the granting of options.

Now, I remind corporate counsel to not forget the fact that promotions can occur in the executive officer rank at any time during the course of a fiscal year, and to the extent that you are checking your processes and the tightness of your procedures, don't forget those promotions because generally those include very high level executives and you want to make sure that your practices are clean there.

And finally, what are your procedures with respect to these grants? What kind of paperwork, including those ever present grant letters, have to be completed? Who has to sign off on those – on that paperwork? And most importantly, has internal audit recently reviewed those processes?

What issues were raised as a result of those internal audits? And have you recently been involved in an M&A transaction? Did your company recently buy another company whose practices prior to the acquisition need to be reviewed as well?

Remember, we're going back to 2002 and looking at these option awards and you need to think about those issues. In step number two, investigating historical practices, you really want to look to the mid 1990's through 2002.

Those are the timeframes that really were highlighted as part of the reports that Brad and Seth mentioned in their comments. And in addition to looking at timeframes, you want to look at the historic market price of the company's stock on and around the date of each option grant, and obviously that was – the importance of that was commented on earlier.

For each option grant, you want to identify the documents authorizing the grant and insure that they accurately reflect the transaction and demonstrate an adherence to whatever your company policies are.

So the documents that you want to review at a minimum should be the minutes of the meetings of your comp committee, the boards of directors authorizing documents, the records relating to the grant of those options.

Follow it directly from the human resources department to the creation of the grant letters, your SEC filings, and insure that all of those records have appropriately carried out what your company policies are. I don't think the process of looking at the accounting treatment for option awards can be emphasized enough.

This is a huge area because the accounting treatment and tax payments are two areas that if your records are sloppy and for some reason unwittingly have granted in the money options when in fact, it has to do with sloppy record-keeping, the key there is to look at the accounting treatment and insure that the proper amount of executive compensation expense was recognized and that the appropriate taxes were paid at both the company level and the individual level.

And the other part of this that you want to think about is how closely is the process of equity grants coordinated as between executive management to human resources to accounting to tax, and obviously, the law department needs to be involved in that process as well.

Finally, step three in determining that you may have inconsistencies or some weaknesses in your procedures, you want to make a determination as to where they are and identify the scope of the problem. If appropriate, report that problem obviously to executive management and to the board.

And one of the determinations that you need to make is whether those issues in fact are material to your public company, and if so, whether to report to the SEC or to the proper regulatory agencies. As part of that determination, companies need to determine whether the problems may cause the company to delay SEC filings, which has a whole different set of ramifications.

Going back to corrective action, you want to properly account for backdated options to correct the issues and you want to determine whether back taxes are owed on executive compensation.

Going forward, in looking at your stock option or equity award plans, consider the size and constitution of the compensation committee, review the procedures for the granting and ultimately awarding of those equity grants.

And obviously company procedures for the timing of those equity grants have to be scrutinized very carefully and set appropriately for new processes. You want to implement procedures to insure that the option grant dates coincide with grant authorizations and obviously, do not forget to review your processes around employment agreement language, your offer letters to prospective candidates, and so forth.

Let me just quickly wrap up by talking about five or six issues of concern that you ought to think about in this process. And number one I think has certainly been reflected in some of the recent media about the way in which options have awarded. Is too much power vested in the hands of one or a few executives to grant options?

And who may also benefit from the option and equity grants? That is really key. You want greater transparency in this process. You want obviously the comp committee and the board to be involved.

You want them to be aware of grants and make sure that if you have delegation of award grants that the board and comp committee are – you have a process for reporting those after they have been granted.

You want to think about those options and equity granted at any time during the year and certainly on hire date and promotion date. And then finally, one final issue of concern and then I'm going to turn this back to Jonathan, is the question of whether executives who have received improper gains as a result of exercising stock options, should they repay those gains?

One company has already come out and stated that they have taken that approach, that executives voluntarily repaid equity grants that had already been exercised, even though the underlying processes were only books and records type and no fraud was found.

So with that, I'm going to turn it back to Jonathan, and hopefully we can use the rest of our time for questions.

Jonathan Yellin: Thank you Chris. I want to thank all of our speakers, and of course, I want to thank all of you who have joined today's presentation. I'd like to note that in link number nine on your screen, you'll see the Web evaluation form. The ACC would, and of course, the speakers would love for you to fill those out and send them in.

I'm going to throw this out to the panel. There were a series of questions that were sent in by e-mail and I would just like to open the discussion. If someone wants to jump in, we can either go down the line or if any of you are prepared to answer any of the particular questions, because there were a number of questions, I'd like to open that up now.

Gail Standish: This is Gail Standish. I think we probably should just go down the line because I was trying to page through some of them and it looks like most of them sort of go chronologically with the way we spoke. So I think the first couple look like they are directed at Brad.

Jonathan Yellin: OK, Brad, do you want to try to take a crack at those?

Operator: Brad, go ahead and unmute your phone.

Brad Cornell: OK, I'm unmuted. Which one would you like me to do? 6117?

Jonathan Yellin: Yes, why don't we start with the slide 16 ((inaudible)) evaluation?

Brad Cornell: OK. If you go back to that slide, the (call) price is not assumed, it's calculated, and the reason that the (call) price is so much greater is that in one case, the option is in the money and in the other, it isn't.

And the in the money is thought – is significantly affected by the maturity. That's why the one-year option has a much larger affect than the 10-year.

Jonathan Yellin: All right. Thank you Brad. I know as a general counsel myself, the next question from 6193 on the hiring of an employee and the actual date, could somebody take that question?

Gail Standish: Go ahead, is that you Chris?

Christine Edwards: Yes, I can do that. The question is, I'm sorry, we're scrolling back up and my scroller was not going quickly enough. The question is, please confirm if an employee is hired on day one with a promise of options when the board decides, is the date that the board unanimously decides, is that the correct date?

And the answer is yes. If you have a board who is meeting in session there, they're all present, you have a quorum and they unanimously decide, that is the correct date for the option grant.

Gail Standish: This is Gail Standish. The next question relates to slide 20 and it notes that the DOJ has also made complaints for violation for tax law and the SEC for violations of Reg. FK, proxy violations, et cetera.

And I'll give you a little insight from the former prosecutor in that a lot of what gets charged in a particular complaint or a particular indictment depends on which agency or which federal agent brought it to the attention of the prosecutor.

And I had several cases where I did not have an IRS CID investigator involved and would not pay that much attention to the tax violations and would look at other things.

But it really, you know, part of this is driven by the statistics that each agency wants to rack up, so you may start seeing more kitchen sink complaints among even the government agencies as more of the individual agents and agencies themselves jump on and it becomes not just the FBI and the IRS.

The other thing that this does remind me of though, that I didn't mention, is that one of the ways that corporate counsel can attempt to minimize some of these costs is to get these agencies to hold hands in their investigations.

And a lot of folks think that that's really impossible or difficult to do because you get two separate subpoenas, you're dealing with two separate sets of government lawyers, but they really usually are not adverse to trying to track their investigations at the same time.

And since they want generally the same information or at least overlapping information, you can often coordinate with them such that you're giving to them in the same format at the same time.

And that can be a huge cost savings because you're already maybe fighting on multiple fronts between the government, the plaintiff's lawyers and the, you know, the tax consequences, your accountants with the restatement.

If you can at least get most of the government guys standing in line one behind the other instead of coming at you from different sides, that can be very helpful.

Christine Edwards: Yes, I think, Gail, the message in all that is you really need to be proactive and to the extent that the IRS, the SEC and the Department of Justice have now created a task force and they are coordinated, that certainly in-house counsel should be reaching out to their colleagues and the finance, the human resources, internal audit, accounting and other areas to create a task force to take a look at your procedures here.

And that's likely to be something that you'll need in any event with CD&A processes that you'll need as part of the new SEC comp rules.

The next question, which is 6103 for everyone who is looking, if an option is backdated, does it matter that the options do not vest when granted?

Yes, it still matters, even though the options are not vested. The date of the grant is generally the date that the price of the option is set, and even though it may be a 10-year option and it vests a third, a third, a third or something to that extent, the fact that you've backdated it, even though it's not vested, still is a problem. It is really setting the value of the option itself.

Gail Standish: I'm not quite sure where we are on the questions now.

Jonathan Yellin: Well, all right. This is Jonathan. I don't know how much more time we have, but I'll throw out one, which is, can you address the privilege issue?

The question is, I heard that an internal revue might not be privileged in a subsequent derivative litigation. Why would it not be privileged?

Gail Standish: That is a front and center question. You can do an internal review and, you know, especially get outside counsel involved, make it privileged.

The problem is as soon as you get any sniffing around by the government, the chances are that in order to get full cooperation points credit from the government, and in fact to try to prove that you're a good corporate citizen, you're probably going to voluntarily turn over part or all of that internal investigation.

And one of the things outside counsel can help with, at least, is trying to minimize the waiver. And the reason that it may not stay out of the plaintiff's hands is that the recent case law has been that there is – with the exception I believe of the Eighth Circuit, there is no selective waiver.

So even if you have a confidentiality agreement with the government and you're trying to be the best corporate citizen you can and give them information, the chances are that you're going to lose later in the case trying to protect that information from a plaintiff's lawyer.

And in fact, and there is a distinction drawn between attorney/client privilege and work product, but even the work product itself, if it's been shared, it's going to wind up being turned over. You may actually be taking, you know, what you've put together for the government, which is, here's how to make your case against me, thank you, and handing that directly to the plaintiff's lawyers.

Now you can choose not to waive the privilege. The DOJ at this point is still saying that one of the things that they will consider is waiver of the privilege.

There is recent movement in that the U.S. – the Sentencing Commission, the Sentencing Guidelines Commission, has now said that, you know, it's really not a good thing for the government to be asking for waiver of the attorney/client privilege, so that there's – that's not supposed to be considered in a sentencing issue anymore.

But it still doesn't stop the government from saying, you know, I'm going to consider you a better corporate citizen if you give me my case with a bow wrapped around it.

Christine Edwards: Gail, let me make two other practical points here too in terms of internal review by corporate counsel.

One thing that probably has not escaped your attention is the fact that there have been a number of general counsels who have been implicated in the stock option backdating cases, simply because of their involvement with the board of directors and as corporate secretaries. So one of the things that you want to avoid is becoming a witness or a target of one of these cases.

And the second thing is the board of directors is going to want to know that the review was independent, that they can rely on that and to the extent that there is something, this issue is under close scrutiny, it might be appropriate to be able to say to the board of directors by executive management, this review was done by independent outside counsel reviewing, you know, our practices and we can say, you know, here are our problems or we don't have any problems or whatever the results are.

Jonathan Yellin: OK. I'm not sure if we have time for more questions. I'm going to ask the ACC if – do we have more time for questions?

(Jackie): We can take one more.

Jonathan Yellin: OK. I guess there's a – there's a factual one is, are copies of the slides available to the participants and can questions be answered off line by the participants if they so choose?

That's to the ACC I would think.

(Jackie): Well, in the link box, in the middle of Section – of the box that's on the left-hand side of the screen, there is a link to the Web cast slides. It's in PDF format, so it can be downloaded. And the questions can be answered in hard copy and they will be posted as a handout on the archives for the Web cast.

Gail Standish: OK. And to the extent that, you know, any questions didn't get answered or posted here, I believe that there are links to all of our e-mail, all of the participants, and I know that we'd be more than happy to respond to your individual questions.

Christine Edwards: Absolutely.

Jonathan Yellin: OK. With that, (Jackie), I'll turn it over to the ACC for any final remarks.

(Jackie): We'd like to thank everyone for attending today's Web cast. Again, we would like to remind you to click on the link for the evaluation form and complete the information there. Your feedback – your feedback is invaluable.

Also, I'd like to advise all of our listeners that the ACC 2006 annual meeting is scheduled for October 22 through the 26, and we have extended the regular rate until September 15. So if you have not registered for the annual meeting, you can register at the regular rate until September 15 by going to the ACC Web site at www.acca.com, and there will be information on the home page.

Again, we'd like to thank all of our presenters. We'd like to thank our sponsors, Winston & Strawn at CRA, and we invite you to participate in future Web casts.

Jonathan Yellin: OK, thank you.

END