Even if you have been living under a rock, it is unlikely that you have missed the fact that the government's investigations of stock option "back-dating" have recently gone into overdrive. What started last year with a few investigations has now grown to include well over 40 public companies. The media focus on the issue has been intense and each day more companies are announcing internal and government investigations. Of course, securities class action lawsuits have followed not far behind – and more will surely be filed.

The focus of the government investigations are several practices lumped under the heading of "back-dating." There appear to be two general categories of practices garnering the most attention. First are cases where options were deemed to have been granted on a date before the grant was actually approved. Because options are generally priced at the market price of the underlying stock on the date of the grant, "back-dating" the grant allows the use of hindsight in selecting a grant date that results in the lowest possible option price. The practical effect is that when the options were actually granted they were already "in the money" and more valuable than they would have otherwise been (increasing the compensation to the recipient of the options). Suspicion that this practice may have been occurring was sparked by academic and media analyses of certain companies that showed patterns of option grants occurring almost exclusively on days when the companies' stocks were trading at periodic lows – a pattern that was statistically unlikely to have occurred without the benefit of hindsight.

The second practice being examined is the granting of options shortly before substantial increases in companies' stock prices caused by the release of positive information about the company. The suspicion in the media has been that corporate officers used "inside information" in granting options when they knew the price of the company's stock would soon increase. Although not technically insider trading, regulators are concerned that insiders may have improperly taken advantage of confidential company information to grant options that would soon be in the money.

While some of this conduct may have been intentionally improper, much of it was not. Some practices that were routine years ago are now being investigated and there is a real danger of innocent conduct being swept up along with improper in these investigations. For example, many companies routinely granted options as of the date they were authorized, even though it may have taken weeks thereafter for the formal written authorizations to be signed by board members. One of the emerging challenges for companies involved in the options investigations is determining if the practices under scrutiny were the product of intentional misconduct or just imperfect procedures.

Public companies face several potential consequences from improperly granted options. For example, an option that was actually "in the money" when granted may have expense and tax consequences different from that which the company originally recorded on its financial statements. These errors may be significant enough to force a restatement of prior financial statements. Also, the company's previous disclosures about compensation and options practices may have been materially incorrect.

The steps that a public company should take are fairly straightforward. A review of past grant practices should be undertaken - preferably under the supervision of the audit committee or a special committee of the board. If any questionable grants are discovered, a more formal internal investigation should be conducted by the audit or special committee. Depending on the circumstances, early public disclosure and self-reporting to regulators should be considered. Even if no problems are uncovered, the company should take this opportunity to strengthen its options procedures to help ensure that no problems develop in the future - although to some extent the provisions of Sarbanes-Oxley have reduced the likelihood of these failures recurring.

Often overlooked in discussions of the backdating issue is what individual officers, directors and employees should do. The SEC in particular has been quite clear recently that it will hold individuals responsible for improper corporate behavior. Companies and individuals should therefore expect the government to closely scrutinize the conduct of the officers and directors who approved questionable option grants, the recipients of the grants and the roles of non-officer employees who participated in implementing the grants (especially if any of these individuals also certified the company's financial statements). Officers, directors and employees cannot treat these investigations lightly. Exacerbated by the intense media attention, there is too great a danger of what were formerly accepted practices or innocent errors being misconstrued as intentional misconduct. It is therefore imperative that individuals seek their own counsel as soon as possible when an internal or government investigation begins.

JAHAN P. RAISSI *Mr. Raissi is a partner at Shartsis Friese and co-Chair of the firm's* Securities Enforcement Defense Group*. Prior to joining the firm he was an enforcement attorney with the Securities and Exchange Commission's Division of Enforcement in Washington, D.C. Mr. Raissi has represented dozens of public companies, audit committees, officers, directors, and other individuals and entities in investigations conducted by the SEC, U.S. Attorneys, state attorneys general, stock exchanges and other self-regulatory organizations, as well as in litigation in state, federal and administrative forums.*

*Mr. Raissi can be contacted by telephone at (415) 773-7219 or by e-mail at jraissi@sflaw.com.*
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