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Can Companies Issue Options, Then Good News?

SEC Is Divided on Practice Known as 'Spring Loading;' Critics See 'Insider Trading'

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New controversy is brewing over the way companies dole out stock options, this time over the practice of granting them just days before announcing good news -- an effort to give executives a quick profit on paper.

Known as "spring loading," such options grants have generated heat in recent days. While spring loading is different from "backdating," another type of options timing, corporate critics blast it as a form of insider trading. Defenders call it a legitimate form of compensation -- and their ranks include a commissioner of the Securities and Exchange Commission.

Options give recipients the right to buy a share of stock at a set price, typically the closing share price on the date a grant is made. Companies that backdate are setting the grant date retroactively to align with a stock's low point, creating an instant paper gain.

By contrast, spring-loaded options usually are priced the same day they are granted. The catch: Companies are aiming to build a quick, expected gain into a grant, by assuming that good news -- like an upbeat earnings forecast -- will push the stock price up in coming days.

The SEC is investigating at least 50 companies for the timing of their options, and while there is wide agreement that backdating is wrong in most cases, there appears to be division over spring-loading. The divisions underscore a broader debate over the myriad ways companies grant options and whether or not some practices are, or should be, banned.

In a speech Thursday before the International Corporate Governance Network, Republican SEC Commissioner Paul Atkins gave a spirited defense of spring loading, calling it a legitimate and low-cost way for boards to efficiently compensate executives. He rejected claims that such awards amount to trading on inside information.

"Boards, in the exercise of their business judgment, should use all the information that they have at hand to make option-grant decisions," Mr. Atkins said. "An insider-trading theory falls flat in this context, where there is no counterparty who could be harmed by an options grant. The counterparty here is the corporation -- and thus the shareholders."

CRYING FOUL

Quickly, some investor groups cried foul. "Let's step back and take it out of the legal domain. This is just not fair," said Ann Yerger, executive director of the Council of Institutional Investors. "I don't think any rational individual or director or executive could argue it is fair. The whole point is to motivate and incentivize. To do this and set up an award so they're already in the money is so unfair. I think it's a mark of poor integrity."

Mr. Atkins's speech came just a few weeks before commissioners are to vote on a rule overhauling rules for how executive compensation is disclosed. The agency is working to include guidance on options-timing, SEC Chairman Christopher Cox has said.

Corporate lawyers and some SEC commissioners have said the pending disclosure rule tackles some of the concerns over backdating. Others already have been addressed by other rules, such as one shortening the amount of time in which executives must file beneficial-ownership forms, and the new accounting rule requiring all options to be expensed.

The question is whether other practices are, or should be, on the agenda. Mr. Atkins has "laid out a marker," says David B.H. Martin, a former SEC official who is now a partner at Covington & Burling. "He's not going to be swayed by public opinion. He wants to analyze things openly."

In an interview Friday, Mr. Atkins defended his position on spring loading, pointing out that options are designed to give executives a long-term incentive to boost performance. "You might have a temporary transfer of wealth from the shareholder to the employees in a case where there's a pop in the price, but again, these are options," he said. "If they are properly constructed and are meant to try to retain people for the long term, they're going to have to survive for 20 quarters, or 40 quarters or 200 quarters."

The debate illuminates some of the challenges facing the SEC as it wades into the options-timing issue. The agency sees backdated options as at least problematic -- especially if not disclosed -- since they carry a strike price -- the price at which they can be redeemed -- lower than the market price on the date they really were granted.

Accounting rules demand that such "discount options" be expensed on the company's books. The tax code disqualifies them from certain corporate deductions and exemptions. And companies that didn't disclose the backdating -- or implied in their filings that they didn't backdate -- can face serious securities violations.

Options timed to news may not be as problematic, since their strike price is the market value on the date of grant. But no consensus has yet emerged from the SEC.

Consequently, the agency, which is looking at several different spring-loading cases, could do nothing, or take any of several tacks in arguing that spring-loaded options aren't kosher.

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The simplest case is to argue that companies that engaged in spring-loading mislead investors by not disclosing that options are awarded with foreknowledge of the impending good news. That's how the SEC has approached the case of Analog Devices Inc., a Norwood, Mass., technology concern that is also being investigated for backdating.

A tentative settlement that Analog reached with the SEC states that it failed to adequately disclose that it priced stock options before the release of favorable financial results. In one of those instances involving options grants in November 2000, directors as well as officers were the recipient of the grants, according to the terms of the proposed settlement. The Analog case has not yet been brought before the full commission for a vote.

Cyberonics Inc., a Houston medical-device maker, drew questions for a June 2004 grant made to several executives on the day a Food and Drug Administration advisory panel recommended approval of a Cyberonics device. Trading in Cyberonics was halted that day. Grants carried as their exercise price the closing price of the prior day.

After trading began again, shares leapt 78%.

An analyst at SunTrust Robinson Humphrey questioned the grant in a research report last month. The SEC is conducting an informal inquiry of Cyberonics, and federal prosecutors in Manhattan have subpoenaed the company. Cyberonics has called the analyst report "misleading" and said it properly accounted for the options.

INSIDER-TRADING RULES

Another approach for the SEC could be to argue that spring-loaded grants violate insider-trading rules, particularly if directors with knowledge of the news give options to themselves, or if executives conceal good news from directors in urging them to grant options. In a famous insider-trading case that the SEC brought against mining concern Texas Gulf Sulphur Co. in the 1960s, a court found that executives who received grants before the company announced a big mining discovery violated federal securities laws. In that case, the compensation committee was unaware of the pending news at the time of the grants.

As for taxes, the implications of spring-loading are "not as clear as with options backdating," says S. James DiBernardo, a partner at Morgan, Lewis & Bockius LLP who specializes in compensation tax issues.

Mr. DiBernardo says he "wouldn't be surprised" if the IRS tries to make the argument that spring-loaded options are also discount options, and thus come with the same tax "parade of horrors" that follows backdated options. But, he says, such an argument would be "much, much more difficult" for the IRS to win. Among other things, the IRS would have to establish what was the "true" market value on the day the spring-loaded options were granted, and it isn't clear how that could be done, he says.

The IRS declined to comment Friday.

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