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Options Backdating: The New Wave of Securities Lawsuits and Investigations

Back-dating Stock Options:
An Overview

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I. Introduction

The Spring and Summer of 2006 have seen unprecedented scrutiny by regulatory agencies, shareholders and the press of the stock option grant practices of numerous publicly traded companies. Since March 2006, more than 50 issuers have announced that they are conducting internal investigations into past options practices, are the targets of Securities Exchange Commission ("SEC") or Department of Justice ("DOJ") investigations, and/or have been named as defendants in private class action or related derivative litigation.

At issue are stock options that are granted as part of executive compensation packages. It appears that some issuers retrospectively selected the date upon which the option was considered "granted" – a date that usually defines the price the executive must pay to purchase the issuer stock underlying the options – to coincide with a date on which the issuer's stock price was particularly low. This "back-dating" of the grant date enabled the executives receiving the options to exercise the options at a relatively low price, creating an instant paper profit and increasing the potential gains the executives would enjoy when the options were exercised and sold at a higher price.

The regulatory interest was apparently prompted by a 2005 University of Iowa study of stock price movements around the time of option grants, which concluded that certain issuers regularly granted options when their share price was at a low point.[1] Interest in the practice by regulators and shareholders kicked into overdrive by the publication on March 18, 2006 of a similar Wall Street Journal analysis of a pattern of stock option grants between 1995 and 2002, and the subsequent performance of the underlying stock. The analysis showed a pattern of options

being granted immediately before a run up in the underlying share price, and concluded the likelihood of these patterns occurring by chance was "wildly improbable."[2] Since publication of the Wall Street Journal analysis, the media have regularly published largely critical articles questioning the role of issuers, executives and auditors in the practice of granting stock options.

This negative press notwithstanding, it does not appear that back-dating is *per se* illegal. However, it does give rise to questions regarding the issuer's compensation procedures, the adequacy and accuracy of its public disclosures, financial statements and tax accounting. This article explains the practice of options back-dating, and provides an overview of the potential implications of the practice under the securities and tax laws**.**

II. Understanding the Practice of Back-dating.

While the term "back-dating" has been widely adopted as a pejorative description of the retrospective pricing of stock option grants, it does not appear to be a term of art. Thus, it is important to understand the practice to which the term refers in order to understand the implications and potential exposure.

A stock option is a form of compensation granted by an issuer to its executive that gives the executive the right to purchase issuer's shares at a fixed price, or "exercise price." An option is back-dated when the issuer selects a date in the past on which its stock was trading at a low price, and retrospectively "grants" the option as of that past date. This enables the executive to exercise the option at a lower price than the stock's market price on the day the issuer's board or compensation committee actually approved the grant.

During the late 1990s and early 2000s, when much of the currently reported back-dating allegedly occurred,

executives were required to report an option grant to the SEC within 45 days after the company's fiscal year end.[3] This extended reporting period made it easier to engage in back-dating because it provided a fairly long time within which to identify and disclose a date with a low stock price. On August 27, 2002, pursuant to the Sarbanes-Oxley Act of 2002 (the "Act"), the SEC amended the reporting rules.[4] Today, Section 16(a) of the Securities Exchange Act, and Rule 16a-3 promulgated thereunder[5], require executives to disclose stock option grants before the end of the second business day following the day on which a transaction resulting in a change in beneficial ownership has been executed. The effect of this reporting change is to significantly reduce the ability to engage in back-dating.[6]

Back-dating carries an inherent cost to the issuer. The issuer must account for options granted with an exercise price that is lower than the stock price on the grant date as a compensation-related expense. As with any other expense, this compensation-related expense reduces the issuer's net income and profits. In addition, when an executive exercises his back-dated options and purchases the issuer's stock at a reduced price, the issuer receives less revenue from the stock sale than it would from an ordinary open market sale. And back-dating options may dilute the incentive that options are understood to provide an executive to align his interest with those of the issuer and shareholders.

Today back-dating appears to have been even more costly. The compensation-related expense must be properly accounted for, the practice and its impact fully and fairly disclosed and appropriate taxes paid. However, if press accounts are to be believed, a not insignificant number of issuers seem to have tripped up in one or more of these areas. And even if back-dating was properly disclosed, scrutiny by the SEC, DOJ, federal tax authorities and the plaintiffs' bar has imposed yet more cost. Securities and tax rules and

regulations provide areas of potential exposure, suggesting that, at a minimum, past or current back-dating should be a cause for concern for issuers and executives.

III. Back-dating May Have Potential Legal Consequences Under the Securities Laws.

1. Accounting Issues Created by Back-dating.

Options are a form of employee compensation. Issuers granting options must determine and account for the value of those options. Under Generally Accepted Accounting Principals ("GAAP") an issuer must record the value of the option as a compensation-related expense.[7] A failure to include such a compensation-related expense in an issuer's financials would result in an underreporting of expenses and an overstatement of net income and profits.

Section 13(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), and Rules 12b-20, 13a-1, and 13a-11 promulgated thereunder, require issuers to file accurate periodic and current financial reports containing all material information necessary to make the required reports not misleading.[8] The Exchange Act further mandates that financial statements be prepared in conformity with GAAP.[9]

Prior to January 1, 2005, issuers typically accounted for options-related compensation expenses pursuant to the intrinsic value method described in APB Opinion No. 25, "Accounting for Stock Issued to Employees."[10] Under the intrinsic value method, the compensation expense attributed to a stock option grant is calculated as the difference of: (i) the exercise price and (ii) the quoted market price of the underlying stock on the measurement date, defined as the "first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any."[11] Pursuant to most stock option plans, the measurement date is the date that the

issuer's board or compensation committee approves the grant to the executive.[12]

Pursuant to the intrinsic value method, if the issuer grants an option with an exercise price *at or above* the quoted market price of the stock on the measurement date, then the issuer need not recognize any compensation-related expense for the option. However, if the issuer grants an option with an exercise price *below* the quoted market price of the stock on the measurement date, that price difference is a compensation-related expense that the issuer must record. Thus, as long as the issuer granted options at an exercise price at or above the quoted market price on the measurement date, it could provide compensation to its executives without incurring a related compensation expense that would impact its net income and profits. This benefit was particularly important to high-tech start-up companies, which tended to be cash-poor, and relied on stock options to attract and/or retain employees.

An arguable weakness of APB Opinion No. 25's intrinsic value method is that it seemingly ignored the possibility that an option granted with an exercise price at or above the quoted market price would someday increase in value as that market price went up. Consequently, in October 1995, the Financial Accounting Standards Board ("FASB") offered an alternative method for valuing stock-based awards, FASB Statement 123, "Accounting for Stock-Based Compensation." FAS 123 allowed issuers to either continue valuing options using the intrinsic value method, or use the "fair value" method and employ option pricing models such as the Black-Scholes or binominal models.[13] If an issuer continued using the intrinsic value method, it had to disclose in the footnotes to its financials a pro forma income calculation of what the compensation expense would have been using the fair value method. Over the next decade, the majority of companies continued to use APB Opinion No. 25's intrinsic value method.[14]

Thus, under the applicable GAAP rules in effect until 2005, an issuer that granted an option with an exercise price below the quoted market price of the stock on the measurement date was required to recognize a compensation-related expense for that option. Moreover, the issuer had to calculate the value of that option – and the corresponding compensation-related expense – as the difference between the exercise price and the market price on the date the board or compensation committee actually approved the grant.

It appears that some issuers and executives who back-dated option grants may have calculated the options' value using the back-dated date as the measurement date, rather than the date the issuer actually approved the grant as required by GAAP. In this way, the issuer granted the options with an exercise price below the market price but calculated its value as if it had been granted with an exercise price at or above the market price. By calculating the option's value using the back-dated date as the measurement date, the issuer may have understated its compensation-related expenses in its financial statements and public disclosures. If the amount of those understated compensation-related expenses are deemed material, the issuer may need to restate its financials back to the date when the stock options first vested through the life of the option.

2. Disclosure Issues Created by Back-dating.

Because the practice of back-dating and related accounting treatment could result in inaccurate statements in public disclosures and financial documents, the practice may expose issuers and executives to claims for liability under the securities laws.

Under Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder, it is a violation for an issuer to make a material false or misleading statement or omission in its public disclosures.[15] A financial statement that is not

prepared in accordance with GAAP is presumptively misleading.[16] Similarly, any public statement by an issuer that those financials are prepared in accordance with GAAP may be deemed inaccurate, as well.

The issuer's failure to disclose that it back-dated options may render public statements about the issuer's executive compensation inaccurate. The fact that the back-dating practice enabled the executive to enjoy an immediate paper gain, while causing the issuer to incur a compensation-related expense, may be deemed a material feature of the plan that a reasonable shareholder or investor would consider important to an investment decision. Also, an issuer may have a duty to disclose back-dating if the practice seemingly contradicts any statements in the issuer's publicly disclosed stock option plan. Many issuers' stock option plans expressly state that options are granted with an exercise price at or above the market value on the date the issuer approves the options. That statement may be inaccurate if the issuer back-dated stock option grants under the plan.

Inaccurate statements about stock options grants that appear in connection with initial or secondary public offerings may expose issuers and executives to claims for liability under Sections 11 and 12(a)(2) of the Securities Act of 1933 (the "Securities Act"). Sections 11 and 12(a)(2) impose strict liability for any material misstatements in a registration statement or prospectus made in the context of an initial or secondary public offering.[17] In a matter filed prior to the recent focus on back-dating stock options, one court held as a matter of law that the failure to disclose the back-dating of stock options was a material omission and grounds for liability under Sections 11 and 12(a)(2). *See Primavera Inv. v. Liquidmetal Techs., Inc.*, 403 F. Supp. 2d 1151, 1157 (D. Fla. 2005). In Primavera, the plaintiffs alleged that the historical financial data contained in the defendants' prospectus was false due, in part, to the defendants' failure to properly account for stock option compensation expenses in

violation of GAAP. The court found the misstatement material, holding that "[a]ny reasonable investor contemplating investing during a company's IPO would want to know whether the company was overstating its financial earnings in violation of GAAP." *Id.*

3. Back-dating and Specific Disclosures Mandated Under the Securities Laws.

The practice of back-dating stock options also may implicate the specific terms and procedures governing the operation of the stock option plan, as well as the way in which the executive calculates his or her compensation. Accordingly, back-dating may raise questions about the accuracy of disclosures regarding stock option plans and executive compensation that are specifically mandated by the securities laws.

A. Back-dating and Disclosures under Section 14 of the Exchange Act.

An issuer generally grants stock options pursuant to the terms of an employee compensation plan. Under Section 14 of the Exchange Act, and rules promulgated thereunder, whenever shareholder approval is required with respect to a compensation plan, the issuer must accurately disclose the plan's material features along with any action to be taken regarding the plan.[18] Schedule 14A specifically requires an issuer to accurately disclose the material terms of any option grant, including the grant date, the exercise price and the federal tax consequences from the grant and exercise to both the issuer and executive.[19]

Schedule 14A also provides that when proxies are solicited for action related to the granting of options to purchase securities, the proxy statement must include information specified in Item 402 of Regulation S-K.[20] Item 402 requires a Summary Compensation Table identifying the

compensation of the CEO and the other four most highly compensated officers for the previous three fiscal years, including stock options.[21] Importantly, Item 402 requires two disclosures that may be implicated when an issuer back-dates stock options. Specifically, if the issuer grants an executive an option with an exercise price that is less than the quoted market price on the grant date, the executive must disclose: (1) the option exercise price and, in a column the executive must add to the table, the market price on the grant date, and (2) the value of the options at grant-date market price.[22]

Arguably, an issuer that back-dated options would have to disclose in Item 10(b)(2) and Item 402 that those options were granted with an exercise price below the market value on the date the board or compensation committee approved the grant. In addition, if a company fails to apply the proper tax treatment to back-dated stock options, its Schedule 14A disclosures may include inaccurate statements regarding the federal tax consequences from the grant and exercise. (For more on potential federal tax consequences, see Section IV below.)

B. Disclosures Mandated by the Sarbanes-Oxley Act of 2002.

The Sarbanes-Oxley Act of 2002 (the "Act".) requires an issuer and its chief executive officer and chief financial officer to publicly certify the accuracy of its financial statements. An issuer's failure to properly account for compensation expenses related to back-dated stock options may render those certifications inaccurate.

Section 302 of the Act requires that an issuer's chief executive officer and chief financial officer publicly certify that the issuer's financial statements are accurate, complete and fairly present the issuer's financial condition.[23] Section 302 also requires that the CEO and CFO publicly certify that

they have evaluated the issuer's internal controls and have not disclosed any "significant deficiencies" in those controls. Furthermore, a CEO and CFO who file the certification knowing that the financial reports accompanying the statement are inaccurate may be subject to criminal penalties, including fines and prison.[24]

Issuers and executives who back-dated option grants, but who did not disclose the practice and/or account for compensation-related expenses pursuant to GAAP, may find that these certifications mandated by Sarbanes-Oxley are inaccurate. Further, if the issuer is required to restate its financial reports, the CEO and CFO may be required to disgorge bonuses or other compensation. Under Section 304, if the SEC establishes that an issuer was required to restate its financials because of misconduct, a CEO and CFO may have to disgorge to the issuer certain compensation earned in the twelve months after the incorrect financial statement was first issued.[25]

4. Back-Dating and Short-Swing Profits Under Section 16b.

Executives who received back-dated options may be deprived of the exemption from the prohibition on short-swing profits by insiders under Section 16(b) of the Exchange Act.

Section 16(b) generally seeks to prevent executives from profiting from the sale of issuer securities based on non-public information by requiring the executive to disgorge any short-swing profits.[26] To further that purpose, Section 16(a) requires an executive who is granted an option to purchase issuer stock to disclose and accurately describe the terms of that option grant on Form 4.[27] Under Rule 16b-3(d), a stock option granted to an executive is an exempt purchase, and not part of a short swing transaction subject to disgorgement, if: 1) the option grant is approved in advance by the board of

directors or a committee of non-employee directors; 2) the option grant is disclosed to shareholders in compliance with Section 14 of the Exchange Act and approved in advance, or is retroactively ratified by the stockholders; or 3) at least six months pass from the time of the option grant to the executive's disposition of the underlying security.[28]

These exemptions, however, may be unavailable to an executive whose stock option grants were back-dated. First, if the issuer failed to disclose in its proxy statement that it had back-dated the options grant, the executive may be foreclosed from relying on the "shareholder disclosure" exemption. Second, if back-dating is not permitted under the terms and conditions of the stock option plan, or if the board or compensation committee unknowingly authorized the back-dated grants, the legitimacy of the board's decision may be challenged. Arguably, if the board acted improperly in granting the back-dated option, the "board approval" exemption may not apply.

If those exemptions do not apply to the grant of back-dated options, the grant will be considered a non-exempt purchase by the executive. The purchase date will be the date the board approved the grant.[29] This non-exempt purchase would then be matched against any sales by the executive within a six month period, and to the extent it is determined that the transaction resulted in a profit, that profit is subject to a disgorgement action by the issuer or a shareholder.

IV. Potential Issues Raised by Back-dating Under the Federal Tax Laws.

Because stock options are considered a form of employee compensation, they create income tax liabilities for executives and opportunities for tax deductions for issuers. The failure to apply the correct tax treatment for back-dated

stock options may have significant financial and legal implications for both the issuer and the executive.

1. Tax Treatment of Back-Dated Stock Options.

There are two basic types of stock options by which issuers compensate their employees: incentive stock options ("ISOs") and nonqualified stock options ("NQSOs"). The tax treatment of each differs significantly. An executive need not recognize any taxable income on ISOs at the time the options are granted or when the ISOs are exercised.[30] Rather -- assuming the executive meets the requirements of the ISO holding period[31] -- when the executive sells the underlying stock acquired by the ISOs, the executive realizes the difference between the exercise price and the sale price as a long-term capital gain at the time of sale.[32] The issuer generally does not enjoy a tax deduction for any compensation element inherent in the ISO; that is, the issuer receives no corporate tax deduction for the difference between the exercise price and the quoted market price on the sale date.[33] Further, the issuer pays no FICA withholding upon disposition of the shares by the executive.[34]

However, options must meet certain criteria in order to qualify as ISOs. The stock option must have an exercise price at least equal to the market price at the time of the grant and be granted pursuant to a plan approved by shareholders.[35] Back-dated stock options that are granted at an exercise price that is less than the market price do not qualify for the tax treatment applied to ISOs and would have to be treated as NQSOs.

The taxable event for NQSOs occurs when the option is exercised. An executive who exercises back-dated options must pay tax and FICA withholding on income calculated as the difference between the exercise price and the quoted market price on the exercise date.[36] The issuer is generally

entitled to deduct that income from its corporate taxes as a compensation-related expense, and must pay its share of FICA withholding.[37]

Back-dated stock options would not qualify as ISOs because the exercise price of the options is below the market price on the grant date. Accordingly, the issuer and executive must treat the options as NQSOs in calculating federal taxes. An issuer could be liable for the amount of income tax and FICA that it failed to withhold upon the executive's exercise of the back-dated option, in addition to interest and potential penalties. That amount could be significant, depending on the number of back-dated options subject to improper tax treatment. An executive who applied the tax treatment afforded ISOs to back-dated stock options could be liable for unpaid income taxes and withholding that accrued upon exercise of those options, as well as for interest and penalties.

Moreover, an executive who holds back-dated stock options also might face additional tax liability under Section 409A of the Internal Revenue Code.[38] Under Section 409A, discounted stock options, including back-dated stock options, are treated as non-qualified deferred compensation and must have a fixed exercise date. If the back-dated options do not have a fixed exercise date, the executive may be subject to substantial taxes, interest and a twenty percent penalty.[39] Section 409A applies only to back-dated stock options granted after October 3, 2004, or granted before October 4, 2004, but that remain unvested after December 31, 2004.[40] Also, there are alternatives that can be taken to avoid these adverse tax consequences, including increasing the exercise price of the unvested options to match the quoted market price on the date the issuer made the grant or electing a fixed exercise date for the unvested options. Absent some remedial action before the end of 2006, an executive with back-dated stock options that remained unvested in 2005 and

2006 may be liable for unpaid income taxes plus interest, as well as a twenty percent additional penalty.

2. Potential Tax Issues Under I.R.C. Section 162(m).

Issuers who treated back-dated stock options as if they had been granted at the market price on the actual grant date may also face significant consequences under a tax regulation that limits the amount of tax deductions an issuer can take for compensation paid to its CEO and next four highest paid executives. Under IRC Section 162(m), an issuer can deduct only $1 million per year for each of these five executives.[41] Any compensation paid by the issuer in excess of $1 million to each executive cannot be deducted from the issuer's corporate taxes. Section 162(m) excepts certain "performance-based" compensation from the $1 million deduction cap, including compensation realized by an executive upon exercise of stock options.[42] However, this exception applies only to stock options granted with an exercise price at or above the underlying stock's market price on the date the issuer approved the grant.[43] Compensation from stock options granted with an exercise price below the underlying stock's market price on the date the issuer approved the grant does not qualify as "performance based." That portion of compensation realized upon the exercise of options with an exercise price below the underlying stock's market price must be counted toward the $1 million cap when the issuer deducts executive compensation from its corporate taxes. Accordingly, issuers that back-dated options so that they had an exercise price below the underlying stock's fair market value, but treated those options as if they had been granted with an exercise price at or above that value, may have taken deductions for executive compensation in excess of the amounts permitted under Section 162(m). These issuers may have to amend their income tax returns to account for these deductions, and pay additional taxes, interest and penalties.

III. Conclusion.

Back-dating may result in inaccurate statements in financial disclosures and other corporate filings that may give rise to claims under the securities laws, including Sections 10b, 14 and 16 of the Exchange Act, Sections 11 and 12(a)(2) of the Securities Act and the Sarbanes-Oxley Act of 2002. In addition, issuers and executives may face financial and legal consequences under the federal tax laws.

The disclosure and accounting issues raised by back-dating have already provided the bases for securities litigation filed against issuers and executives. Although still in its early stages, the litigation has primarily involved claims purportedly brought on behalf of the company in the form of derivative actions. In addition to alleging violations of the securities laws, these derivative actions allege breach of fiduciary duty claims and seek remedies that include disgorgement of the proceeds from the sale of back-dated options, rescission of the stock option grants and the implementation of more stringent corporate controls. A number of shareholder lawsuits have been filed as well, although the possibility of shareholder actions may be limited if the market reacts ambivalently to an issuer's disclosure that it had engaged in back-dating. Finally, while the SEC and the Department of Justice have announced numerous informal investigations of issuers, as of the date of this article, neither the SEC nor any law enforcement agency has brought a formal action.

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[1] *See* Erik Lie, *On the Timing of CEO Stock Option Awards*, Management Science, May 2005, http://www.biz.uiowa.edu/faculty/elie/Grants-MS.pdf.

[2] *See* Charles Forelle and James Bandler, *The Perfect Payday*, WALL ST. J., March 18, 2006 at A1.

[3] *See* 17 C.F.R. § 249.105 (2006).

[4] *See* SEC Release No. 34-4642; Ownership Reports and Trading by Officers, Directors and Principal Security Holders (August 29, 2002) (http://www.sec.gov/rules/final/34-46421.htm).

[5] *See* 15 U.S.C. § 78p(a) (2002); 17 C.F.R. § 240.16a-3(a) (2006).

[6] Despite the imposition of this two-day window, which would seemingly eliminate the ability to back-date options, a yet-to-be published analysis of stock options granted since August 2002 revealed that roughly 20 percent of the grants analyzed were not reported to the SEC within this two-day period. *See* Randall A. Heron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?*, Journal of Financial Economics (forthcoming), available at http://www.biz.uiowa.edu/faculty/elie/Grants-JFE.pdf.

[7] *See* Financial Accounting Standards Board (FASB) Statement 123 Revised, "Share-Based Payment Statement" (FAS 123(R)) (2004).

[8] *See* 15 U.S.C. § 78m(a) (2002) ("Every issuer of a security registered pursuant to section 12 of this title shall file with the Commission . . . (1) such information and documents . . . as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 12 . . . (2) such annual reports . . . certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports (and such copies thereof), as the Commission may prescribe.) *See also* 17 C.F.R. § 240.12b-20 (2006) ("In addition to the information expressly required to be included in a statement or report, there shall be added any such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading."); 17 C.F.R. § 240.13a-1 (2006) ("Every issuer having securities registered . . . shall file an annual report on the appropriate form authorized or prescribed therefore for each fiscal year after the last full fiscal year for which financial statements were filed in its registration statement. Annual reports shall be filed within the period specified in the appropriate form."); 17 C.F.R. § 240.13a-11 (2006) ("Except as provided in paragraph (b) of this section, every registrant subject to Rule 13a-11 shall file a current report on Form 8-K within the period specified on that form, unless substantially the same information as that required by Form 8-K has been previously reported by the registrant).

[9] *See* 17 C.F.R. § 210.4-01(a)(1) (2006) ("Financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided").

[10] Prior to 1973, public accounting and reporting standards were established by the Accounting Principles Board (APB) and the American Institute of Certified Public Accountants (AICPA). The APB issued APB Opinion No. 25 "Accounting for Stock Issued to Employees" in October 1972 and it became effective December 31, 1972. After 1973, APB's role was taken over by the Financial Accounting Standards Board (FASB).

[11] APB Opinion No. 25 ¶ 10b.

[12] *Id*.

[13] *See* FASB Statement 123, "Accounting for Stock-Based Compensation."

[14] In December 2004, FASB issued Statement 123 Revised, "Share-Based Payment Statement" (FAS 123(R)), which stated that in fiscal years beginning after June 15, 2005, issuers could no longer use the intrinsic value method and report pro forma equity compensation expenses in the footnotes of their financials. Rather, FAS 123R required issuers to expense the fair value of options and other share-based compensation in their income statements. It also required issuers to record compensation costs for the invested portion of previously issued awards. FAS 123(R) does not specify a model to determine the fair value of options, rather it mandates that the model chosen must take into consideration: (1) the award price; (2) the term of the award; (3) dividend rates; (4) volatility; (5) the risk-free interest rate; and (6) the stock price at grant.

[15] *See* 15 U.S.C. § 78j(b) ("It shall be unlawful for any person . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe"); *See also* 17 C.F.R. § 240.10b-5 (2006) ("It shall be unlawful . . . (a) to employ any device, scheme or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security").

[16] *See* 17 C.F.R. § 210.4-01(a)(1) (2006).

[17] *See* 15 U.S.C. § 77k ("In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may, either at law or in equity, in any court of competent jurisdiction sue. . . ."); 15 U.S.C. § 77l(a)(2) (a purchaser of a security may bring a private action against a

seller that "offers or sells a security ... by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements . . . not misleading").

[18] *See* 15 U.S.C. § 78n(a) ("It shall be unlawful for any person . . . in contravention of such rules and regulations as the Commission may prescribe . . . to solicit or permit the use of his name to solicit any proxy or consent or authorization in respect of any security . . . registered pursuant to section 12 of this title").

[19] Item 10(a)(1) of Schedule 14A mandates that the proxy statement "[d]escribe briefly the material features of the plan being acted on . . . ." Item 10(b)(2) requires the issuer to list, "with respect to any specific grant of or any plan containing options . . . submitted for security holder action . . . (A) The title and amount of securities underlying the options . . . (B) The prices, expiration dates and other material conditions upon which the options . . . may be exercised; (C) The consideration . . . to be received . . . for the granting . . . of the options, (D) The market value of the securities underlying the options . . . as of the last practicable date; and (E) The federal income tax consequences of the issuance and exercise of the options, both to the issuer and executive. 17 C.F.R. § 240.14a-101 (2006).

[20] *Id*.; 17 C.F.R. § 229.402 (2006).

[21] *See* 17 C.F.R. § 229.402b (2006).

[22] *See* 17 C.F.R. § 229.402c-2 (2006).

[23] *See* 15 U.S.C. § 7241.

[24] *See* 18 U.S.C. § 1350 (the CEO and CFO must "certify that the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) . . . and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer"). Under § 906, a CEO or a CFO who files a certification "knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $1,000,000 or imprisoned not more than 10 years, or both," with penalties of $5 million or 20 years for a CEO or CFO who "willfully certifies any statement . . . knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section." *Id*..

[25] *See* 15 U.S.C. § 7243 (when "an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws," the CEO and the CFO shall disgorge to the issuer "(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission

(whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period").

[26] *See* 15 U.S.C. § 78p(b) ("For the purpose of preventing the unfair use of information which may have been obtained by such . . . director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of the . . . director, or officer").

[27] *See* 15 U.S.C. § 78p(a) (2002); 17 C.F.R. § 240.16a-3(a) (2002).

[28] *See* 17 C.F.R. § 240.16b-3 (2006).

[29] "For purposes of the rules promulgated under Section 16(b) the acquisition of a securities option is deemed to be equivalent to acquisition of the security underlying that option." *Gryl v Shire Pharm. Group PLC*, 298 F.3d 136, 141 (2nd Cir. 2002).

[30] *See* I.R.C. § 422(a); Treas. Reg. § 1.83-(a)(2).

[31] To qualify for the tax treatment afforded an ISO, the employee must hold the options until the later of two years from the date of the grant and one year from the date the shares were transferred to the employee upon exercise. Treas. Reg. § 1.422-1(b).

[32] The exercise of an ISO can also trigger tax consequences under the Alternative Minimum Tax. I.R.C. § 55, 56(b)(3).

[33] *See* I.R.C. § 421(a)(2); I.R.C. § 421(b).

[34] *See* I.R.C. § 421(a)(2).

[35] *See* I.R.C. § 422(b)(4); I.R.C. § 422(b)(1).

[36] *See* Treas. Reg. § 1.83-3(a)(ii).

[37] *See* I.R.C. § 83(h).

[38] *See* I.R.C. § 409A.

[39] The IRS has not yet made clear what amount of a discounted stock option will be subject to the 20 percent penalty.

[40] *See* I.R.C. § 409A.

[41] See Treas. Reg. § 1.162-27.

[42] *See* I.R.C. § 162(m)(4)(C).

[43] *See* Treas. Reg. § 1.162-27(e)(2)(iv).