

MANIPULATION Nation

Backdating executive stock options still a problem in Canada.

BY LAMIA CHOUROU AND EZZEDDINE ABAOUB



Executive stock options continue to be a hot topic, fuelled by earnings manipulation scandals and excessive compensation packages at major firms. The U.S. Securities and Exchange Commission (SEC) recently launched an investigation into several American companies suspected of manipulating their stock option prices (see for instance Maremont, 2005, and McKenna, B., 2006).¹ As stock options garner attention from American regulators, the issue has prompted similar scrutiny in Canada. Following in the footsteps of the SEC, the Ontario Securities Commission (OSC) announced it is investigating the stock option awards practices of several Canadian companies, while many

other firms have launched their own internal investigations. Although Canadian regulation of stock option awards is considered tougher than U.S. regulation, we do not know whether this tougher regulation is deterring Canadian CEOs from manipulating their stock option awards.

To the best of our knowledge, this is the first study to examine the timing of stock option awards in the Canadian context. Existing literature is focused solely on the U.S., hence there is a unique opportunity to consider the Canadian market. Regulations in Canada and the U.S. differ in key areas with respect to stock option awards and corporate governance practices.² For instance, since the end of 1999, Canadian firms are required to disclose stock option awards within 10 days of the grant date. In the U.S., the Sarbanes-Oxley Act (effective August 29, 2002) reduced the reporting of option grants from 45 days after the company's fiscal year-end to two business days after the grant date. Moreover, public firms in Canada are not allowed to issue in-the-money stock options while, in the U.S., this practice is not prohibited as long as proper accounting charges are taken.

In this study, we investigate the possible timing of stock

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option awards and test the backdating hypothesis. We also examine stock returns around CEOs' option awards before and after August 29, 2002 for Canadian firms listed on both Canadian and U.S. stock exchanges. Canadian firms cross-listed on U.S. stock exchanges must meet the requirements of Canadian as well as U.S. regimes (Sarbanes-Oxley Act). Hence, cross-listed firms have to disclose stock option awards within two business days of the grant date rather than within 10 days. If backdating is the origin of excessive abnormal returns around CEO stock option grant dates, we should observe a significant reduction in excess returns after August 29, 2002.

Yermack (1997) was the first to point out the issue of stock option manipulation by opportunistic managers. In fact, in a sample of 620 CEO option awards, Yermack finds positive abnormal returns after option grant dates. The author analyzes corporate earnings announcements and concludes that CEOs receive stock options shortly in advance of favourable corporate news. While Yermack interprets his findings as CEOs opportunistically timing stock option grants to benefit from positive corporate news, Aboody and Kasznik (2000) attribute the positive abnormal returns identified in a sample of scheduled grants to the manipulation of information released around the stock option grant dates. More recently, Lie (2005) reports negative abnormal returns prior to the grant dates and positive abnormal returns afterwards. He suggests backdating as a potential explanation for the return reversal pattern around grant dates. In other words, executives select an option grant date in the past on which the stock price was particularly low. Heron and Lie (2007) find evidence

consistent with the backdating hypothesis.

In order to test our backdating hypothesis, we collect data on stock option awards granted to CEOs of 196 large Canadian firms from 2001 to 2004. Our original sample includes 632 stock option awards collected from companies' proxy statements. Table 1 below presents the classification of option grants in our original sample: 85% of stock option awards are granted at-the-money while only 7.76% are granted out-of-the money. Interestingly, despite the fact that Canadian regulation prohibits companies from issuing in-the-money stock option grants, 6.32% of the grants in our original sample are in-the-money. We conclude that this indicates a clear violation of Canadian regulation with respect to stock option grants.

The existing studies classify stock option grants as scheduled and unscheduled grants. Following Lie (2005) and Heron and Lie (2007), we define a scheduled stock option grant as a grant that occurs within one day of the one-year anniversary of the prior year's grant date and an unscheduled grant as a stock option grant that does not occur within one day of this anniversary or if no stock options were granted during the prior year. A grant is left unclassified if no information is available to classify it. Since our study focuses on opportunistic timing of option

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Classification of Stock Option Grants

This table provides classification of option grants in our original sample composed of 632 grants to CEOs between 2001 and 2004. The grant dates are taken from firms' proxy statements.

	Option Classification		
	At-the-Money	Out-of-the-Money	In-the-Money
Number of Grants	543	49	40
Percentage (%)	85.92	7.76	6.32

TABLE 1

grants, we only examine unscheduled grants. In fact, opportunistic timing of option grants is unlikely when the grant is scheduled (Heron and Lie, 2007).

We examine stock returns 30 days before and 30 days after the grant date and compute abnormal returns using the market-adjusted model. We exclude option grant events for which we were unable to identify the grant date. We also exclude grants relating to firms with missing returns around the inferred grant date (i.e. grants for which we do not have sufficient stock price data to estimate abnormal stock returns around the grant date). Finally, for firms cross-listed on U.S. stock exchanges, we exclude stock options granted between July 30, 2002 and August 29, 2002.³ This yields a final sample of 443 unscheduled option grant events.

RESULTS

We calculate abnormal returns around 443 unscheduled stock option grants to CEOs between January 1, 2001 and August 29, 2004 using the market-adjusted model.⁴ Figure 1 displays the cumulative abnormal returns (CAR) from 30 days before through 30 days after the option grant dates. Clearly, the average stock price begins to fall approximately 30 days before the grant dates. The stock price movement is reversed immediately after the award dates and starts to rise for at least the next 30 days. The V-shaped pattern around the option grant date displayed in Figure 1 suggests that CEOs are granted stock option awards on the day when the stock price is the lowest. Since the strike price of the option is often equal to the stock price at the grant date, CEOs receive stock options with a low strike price. This makes the

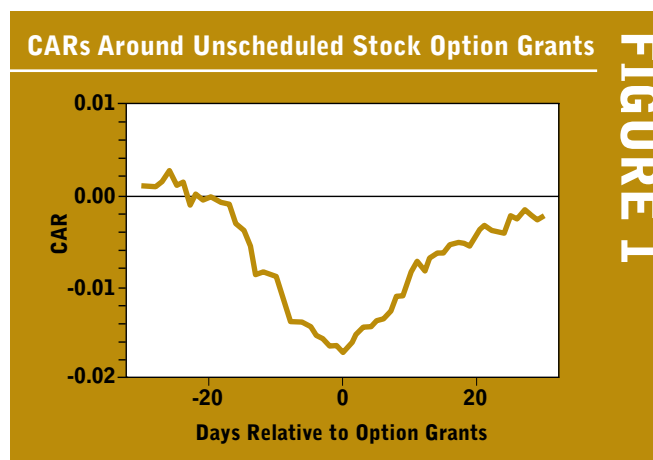


FIGURE 1

options in-the-money subsequently.

Table 2 presents statistically reliable evidence of negative cumulative abnormal returns before grant dates and positive cumulative abnormal returns afterwards. CARs for 30, 20, 10 and 5 days before the grant date are negative and significantly different from zero at the 1% level. Though negative, CAR for (-1, 0) is statistically insignificant. The persistence of CAR is more pronounced after the grant date. In fact, CARs for all periods are positive and significant at the 1% level. For instance, the abnormal return is about 1.5% from the option grant date to 30 days later, indicating that shares perform better than normal in the periods after option grant dates.

This returns pattern is consistent with recent studies such as Heron and Lie (2007). In fact, in a sample of 3,735 option grants, the authors found that average stock prices start to decline at least 30 trading days before the grant dates and tend to increase immediately after the grant dates.

Cumulative Abnormal Returns around Unscheduled Stock Option Grants

This table presents the cumulative abnormal returns (CAR) around unscheduled stock option grants to CEOs between 01/01/2001 to 12/31/2004. Abnormal returns are estimated using the market-adjusted model. Stock prices are taken from CFMRC database while grant dates are taken from firms' proxy statements. *, **, *** Significantly different from zero at the 10%, 5%, and 1% level, respectively.

Days	Number of Days	CAR (%)	p-value	N
(-30 to 0)	31	-1.721***	0.006	443
(-20 to 0)	21	-1.668***	0.001	443
(-10 to 0)	11	-0.851***	0.010	443
(-5 to 0)	6	-0.339***	0.006	443
(-1 to 0)	2	-0.084	0.233	443
(1 to 5)	5	0.352***	0.006	443
(1 to 10)	10	0.848***	0.002	443
(1 to 20)	20	1.311***	0.001	443
(1 to 30)	30	1.500***	0.002	443

TABLE 2

Cumulative Abnormal Returns around Stock Option Grants to CEOs of Cross-listed firms before and since 8/29/2002

This table presents the cumulative abnormal returns (CAR) around unscheduled stock options to CEOs of cross-listed firms before and since 8/29/2002. Abnormal returns are estimated using the market-adjusted model. Stock prices are taken from CFMRC database while grant dates are taken from firms' proxy statements. *, **, *** Significantly different from zero at the 10%, 5%, and 1% level, respectively.

Period	Number of Days	Before 8/29/2002			Since 8/29/2002		
		CAR (%)	p-value	N	CAR (%)	p-value	N
(-30 to 0)	31	-1.069	0.510	106	-1.492	0.262	108
(-20 to 0)	21	-1.648	0.151	106	-1.458	0.193	108
(-10 to 0)	11	-0.786	0.407	106	-0.028	0.950	108
(-5 to 0)	6	-0.190	0.783	106	-0.096	0.794	108
(-1 to 0)	2	-0.121	0.705	106	0.099	0.811	108
(1 to 5)	5	1.015	0.201	106	-0.182	0.720	108
(1 to 10)	10	1.837*	0.053	106	-0.319	0.674	108
(1 to 20)	20	2.897**	0.028	106	-1.146	0.280	108
(1 to 30)	30	3.036**	0.049	106	-0.517	0.663	108

Though our results are less significant compared to the ones reported in American studies, stock price increases and decreases per day are higher as we move towards grant dates. The average cumulative returns from day -30 through day -10 is 0.88%, or 0.04% per day, and from day -9 through day 0 is 0.84%, or 0.08% per day. Thus, the price-decrease per day doubles 10 days before the grants. Interestingly, the same pattern is reported for the period after the grant date. Indeed, the average cumulative returns from day 1 through day +10 is 0.85%, or 0.08% per day, and from day 10 through day +30 is 0.88%, or 0.04% per day.

The above results suggest that Canadian regulations with respect to stock option grants did not discourage Canadian firms from engaging in opportunistic behaviour. Hence, in contrast to the view of Canadian regulators, we should expect a high portion of Canadian firms to be involved in stock option grant manipulation.

TESTING THE BACKDATING EXPLANATION

The results reported above are consistent with the timing of option grants and backdating explanations. The timing explanation suggests that directors time the option grant date opportunistically so that it falls before positive corporate news or after negative corporate news. The backdating explanation means the official grant date is set retroactively.

Similar to Heron and Lie (2007), we exploit a recent change in SEC reporting requirements for stock option grants to test the backdating explanation using a set of

option grants from Canadian public firms cross-listed on U.S. stock exchanges. Under this new reporting regime, firms will have to disclose stock option awards within two business days after the grant date. If backdating is the origin of excessive abnormal returns around CEO stock option grants, then we should document a significant reduction of excess return after August 29, 2002, the day on which the change became effective.

Before August 29, 2002, U.S. firms had to report option grants within 45 days of the company's fiscal year-end; however, Canadian firms cross-listed in the U.S. have to report option grants within 10 calendar days. With this longer reporting period, U.S. firms are likely to be more tempted to backdate than Canadian firms. Therefore, we should expect the impact of the change in reporting requirement on stock returns pattern around grant dates to be less pronounced in Canada than it is in the U.S.

Table 3 presents the cumulative abnormal returns (CAR) for various periods around unscheduled stock option grants to CEOs of cross-listed firms, before and since August 29, 2002. We note that, although negative, CARs before the grants are not significantly different from zero. After the grant dates, however, CAR is positive and significant at the 5% level, except from day +1 through day +5, where CAR is positive but not significant. However, the positive cumulative abnormal returns after grant date disappear after August 29, 2002.

Table 4 presents the abnormal returns (AR) for various periods around unscheduled stock option grants before

Abnormal Returns around Stock Option Grants to CEOs of Cross-listed firms before and since 8/29/2002.

TABLE 4

This table presents the abnormal returns (AR) around unscheduled stock options to CEOs of cross-listed firms before and since 8/29/2002. Abnormal returns are estimated using the market-adjusted model. Stock prices are taken from CFMRC database while grant dates are taken from firms proxy statements. *, **, *** Significantly different from zero at the 10%, 5%, and 1% level, respectively.

Period	Number of Days	Before 8/29/2002		Since 8/29/2002		Comparing AR	
		Average AR (%)	p-value	Average AR (%)	p-value	Mean Difference (%)	p-value
(-30 to 0)	31	-0.016	0.761	-0.040	0.352	0.025	0.721
(-20 to 0)	21	-0.051	0.358	-0.058	0.287	0.007	0.929
(-10 to 0)	11	-0.020	0.827	0.019	0.639	-0.039	0.691
(-5 to 0)	6	0.007	0.959	0.014	0.839	-0.007	0.956
(-1 to 0)	2	0.092	0.279	0.176	0.404	-0.084	0.602
(1 to 5)	5	0.203	0.258	-0.036	0.752	0.239	0.238
(1 to 10)	10	0.184*	0.068	-0.032	0.690	0.216*	0.083
(1 to 20)	20	0.145**	0.032	-0.057	0.293	0.202**	0.018
(1 to 30)	30	0.101**	0.043	-0.017	0.669	0.118**	0.049

August 29, 2002 and AR since August 29, 2002. Similar to CAR, after August 29, 2002 the AR for various periods around grant dates become insignificantly different from zero. The last two columns of Table 4 provide the difference between AR before August 29, 2002 and AR since August 29, 2002 for various periods around grant dates, along with their corresponding *p*-values. Consistent with the backdating explanation, the difference in returns is statistically different from zero.

We may infer the following from the results reported in Table 3 and Table 4: First, backdating indeed shapes the pattern of abnormal returns around the grant dates; second, the new SEC regulation is effective in curbing the opportunistic timing of option grants. This suggests that Canadian regulatory bodies should adopt the SEC-initiated change.

Using data on 443 unscheduled CEOs stock option grants, we find reliable evidence of negative abnormal returns before option grant dates and positive returns afterwards. However, this pattern disappears after August 29, 2002 for cross-listed firms—the day when SEC changes grant reporting to two business days. These results show that Canadian regulations with respect to stock option grants did not discourage Canadian firms from engaging in opportunistic behaviour, while new SEC regulation did. Hence, in contrast to what Canadian regulators think, we should expect a relatively high portion of Canadian firms to be involved in stock option grant manipulation. Based on our empirical results, we suggest that Canadian regulators adopt the SEC-initiated

change by reducing the reporting of option grants from 10 days to two business days. ■

ENDNOTES

1. The investment and media communities have also started their own investigations and have uncovered numerous cases of backdating, forcing several executives to resign (see for instance Forelle and Bandler, 2006).
2. For instance, ownership is highly-concentrated in Canadian public firms but widely diffused in U.S. public firms.
3. The Sarbanes-Oxley Act was signed into law on July 30, 2002, but became effective only starting from August 29, 2002 (see Section 403-b of the Act).
4. The abnormal return is equal to the stock return minus the market return.

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