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Corporate Governance and Backdating of Executive Stock Options*

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1. Introduction

The backdating of stock option grants refers to the practice of using hindsight to select a date in the past on which the stock price was particularly low to be the option grant date. Because stock options typically have an exercise price that is set to the market price of the stock on the grant date, backdating allows executives to receive in-the-money options, thereby enhancing the value of their option grants. As of January 2007, over 200 companies have come under federal investigation by the Securities and Exchange Commission (SEC) and the Justice Department, or have been subject to inquiries from their own boards, over possible backdating practices.[1] Announcements of option-backdating investigations have prompted share price declines, stock downgrades, and, for some companies, financial statement restatements and replacements of board members and senior executives.[2]

The revelation that some companies backdated executive stock options raises concerns about the effectiveness of corporate governance in setting executive pay. For example, the *Wall Street Journal* (WSJ) recently reported that the board of UnitedHealth, one of the alleged backdating firms, allowed its former chief executive officer (CEO), William McGuire, to choose the day of his own option grants, which resulted in several large option awards dated at the years' single lowest closing price (Bandler and Forelle 2006). In addition, questions have been raised about the independence of UnitedHealth's board and compensation committee (Forelle and Bandler 2006b).[3] Arthur Levitt, former chair of the SEC, has referred to backdating as "the ultimate in greed. It is stealing, in effect. It is ripping off shareholders in an unconscionable way" (Forelle and Bandler 2006a).[4]

In this study we examine whether weaknesses in corporate governance are related to the incidence of executive stock option backdating. We expect backdating

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