EXHIBIT "K"
Feds Rip Into Former Brocade Execs

Hannah Clark, 07.21.06, 1:00 PM ET

Taking an increasingly hard line on corporate fraud, federal prosecutors have filed criminal charges against two former executives of data-storage maker Brocade Communications Systems for backdating stock options, even though the accused did not personally profit from their alleged misdeeds.

The case is likely a harbinger of more actions in the growing inquiry into options accounting.

The Securities and Exchange Commission filed civil and criminal securities fraud charges on Thursday against Gregory L. Reyes, the former chief executive of the San Jose-based firm, and Stephanie Jensen, a former vice president for human resources.

The Justice Department joined in the complaint, which alleges that Reyes and other executives manipulated the grant dates of stock options in order to enhance their value. While this kind of backdating isn't illegal, companies must disclose it properly and account for the associated expenses.

The case is notable in part because the Reyes and Jensen did not directly benefit from the backdated options, which were used to reward other employees.

"It signifies that the SEC is taking the option backdating issue quite seriously," says Charles Elson, chair of the John L. Weinberg Center for Corporate Governance at the University of Delaware's Lerner College of Business and Economics. "Going criminal is a pretty big step."

Richard Marmaro, Reyes' attorney, said his client never profited from the options he is alleged to have backdated. "Financial gain is always the motive in securities fraud cases, and here there was none," Marmaro said in a statement. "There is not even an allegation of self-enrichment, or self-dealing. Nor is there any evidence of an intent to misstate the financial statements of the company."

That approach may not work in court. "The defense that they're trying to raise, that they didn't profit personally, is about as irrelevant as I've ever heard," says Harvey Pitt, chief executive of Kalorama Partners, who chaired the SEC from 2001 to 2003.

While Reyes may not have padded his bank account, he could have used the tool to attract talent during the heady years of the dot-com boom, when rapidly-growing information technology firms in Silicon Valley competed for high-skilled workers.

Brocade shares fell 22 cents, or 3.7%, in Friday morning trading, even though the accused executives no longer work at the company. Reyes served as CEO of Brocade from 1998 until January 2005, when the company announced it would be restating several years of financial results because of irregularities regarding stock-option grant dates.

The SEC also filed civil charges against Brocade's former chief financial officer, Antonio Canova, alleging that he learned of the backdating after he joined the firm. According to the complaint, he failed to take action when he learned of the practice, and didn't tell Brocade's auditors and directors about it.

While these were the first charges to be brought in the rapidly growing scandal, they are unlikely be the last. "We really just follow the facts and take them where they lead us," says Patrick Murphy, a prosecutor with the SEC's office in San Francisco, where the charges were announced Thursday. "This case was ready to be filed."

More are sure to follow. At least 80 companies are under investigation for their stock option dating practices, according to the
Others, like the Cheesecake Factory, are initiating internal investigations. Apple Computer recently announced that an internal inquiry had discovered irregularities in options grants from 1997 through 2001, including one grant to Chief Executive Steve Jobs.

"There are almost 17,000 public companies," says Pitt. "One has to believe this isn't a problem confined to 80."
EXHIBIT “L”
Federal authorities issued civil and criminal securities-fraud charges against a former Silicon Valley chief executive and two other executives in a stock-options backdating scheme, signaling they will take a hard line in the widening scandal.

Prosecutors accused 43-year-old Gregory Reyes, the CEO of Brocade Communications Systems Inc. until January 2005, of backdating options he doled out as a "committee of one" to hundreds of employees, boosting the potential value of the options and concealing millions of dollars of compensation expenses from shareholders.

Officials underscored how seriously they view options manipulation by charging not just Mr. Reyes -- who isn't directly accused of backdating his own grants, and who made no profit from them -- but also a former chief financial officer and former vice president for human resources at the firm.

They also indicated that many more executives could face charges related to manipulating options. Securities and Exchange Commission Chairman Christopher Cox said the agency is investigating more than 80 companies.

"The full weight of the federal government is being put behind this effort to stamp out fraudulent stock-option backdating," he said at a San Francisco news conference. He said additional cases likely would be brought in the "coming weeks and months."

The crux of the case brought yesterday is that Mr. Reyes altered the dates of option grants to new employees to increase their value and give Brocade, a San Jose, Calif., maker of switching devices for data-storage networks, an edge in the cutthroat scramble for talent during Silicon Valley's boom days. In doing so, prosecutors said, he violated accounting rules by not recording the proper expenses for the options.

Under a criminal complaint from the U.S. attorney for the Northern District of California, Mr. Reyes faces a single count of securities fraud, which carries a maximum penalty of 20 years in prison. Also facing a criminal-fraud charge is Stephanie Jensen, 48, Brocade's human-resources director from October 1999 through February 2004. She is accused of helping Mr. Reyes with the scheme.

Both also face civil charges from the SEC of securities fraud and filing false documents. Antonio Canova, 44, who
served as the company's finance chief from May 2001 until he left in December, also was charged in the civil case but not in the criminal action.

A lawyer for Mr. Reyes, Richard Marmaro, said in a statement issued before the charges were announced that Mr. Reyes is innocent. Mr. Marmaro lambasted prosecutors for acting "not based on the facts or the merits of this case, but on some perceived need to show quick action." Signaling a key defense argument, he said, "Financial gain is always the motive in securities fraud cases, and here there was none."

Asked about that argument, U.S. Attorney Kevin V. Ryan countered, "We don't have to show personal gain" to bring criminal securities-fraud charges. "Different people have different reasons for what they do and why they do it."

Ms. Jensen's attorney, Jan Little, said in a statement, "Stephanie Jensen is innocent of these charges. Ms. Jensen directed Brocade's Human Resources Department, and she had no responsibility for finance or accounting. These charges are completely wrongheaded, and we will vigorously fight them in court." An attorney for Mr. Canova didn't return a call seeking comment.

Marking the first major charges brought in the recent scandal, the Brocade case is being watched closely at many companies, particularly in California's technology corridor, where dozens of companies are among those being investigated for their past options practices. The focus of the investigations by the SEC and federal prosecutors in several offices is whether grants were backdated to enrich executives, among other possible manipulations. (The investigations appear to be focusing on those who planned and implemented grant programs, not passive recipients of options.)

Employee stock options give recipients the right to buy shares in the future at a fixed price, typically the current market value. Backdating the grant to a time when the share price was lower than it was on the actual grant date increases the potential gain in an option. Doing so without properly accounting for it can lead to financial restatements, tax trouble and possibly criminal-fraud charges.

The Brocade case is the first in which charges have been brought, partly because it has been under way since early 2005, well before most of the current backdating investigations began.

It also has some key differences from other investigations. Many of the companies currently under investigation have top executives who personally profited richly from options grants. That suggests the next wave "is going to have a lot more graphic and colorful and sexy cases," said George Stamboulidis, head of the white-collar defense and corporate investigations practice at law firm Baker Hostetler LLP.

Underscoring the importance the federal government is giving the options-timing investigation, a phalanx of top SEC and Justice Department officials appeared at the news conference announcing the Brocade charges.

The SEC's Mr. Cox warned that backdating "deceives investors and the market as a whole about the financial health of companies that cheat in this way." He added, "It is poisonous to an efficient marketplace."

The charges against Ms. Jensen and Mr. Canova suggested that federal officials won't hesitate to pursue those further down the corporate ladder who allegedly participated in an options-timing fraud.

John Coffee, a law professor at Columbia Law School, said human-resources officials could find themselves in the hot seat as prosecutors attempt to persuade them to cooperate in investigations of senior executives. "This is going to send a shiver through the spines of much of corporate America," he said.

The SEC also showed it won't take a kind view of executives who knew about backdating but signed off on financial statements. The agency said that's what Mr. Canova did, despite hearing misgivings from some employees about the practice. The SEC also alleged that he "helped facilitate" the fraud by directing others to ensure that option
cases matched hiring dates in employee records.

The civil and criminal complaints allege broad backdating at Brocade from 2000 to 2004. The SEC alleged that Mr. Reyes was trying to attract employees to the company with particularly valuable options grants. Brocade's stock price was rising rapidly for part of the period, meaning that every day that passed before employees received their grants decreased potential gains. The complaints allege that Mr. Reyes looked at the stock-price history and picked prior days when the stock was particularly low to date option grants.

Prosecutors charge that Mr. Reyes and Ms. Jensen falsified paperwork so the company didn't need to record expenses for these particularly valuable options. The government alleges that the widespread manipulation of employee grants, presided over by Mr. Reyes, grossly misrepresented the financial position of the company.

Brocade restated results in 2005 after an internal probe into options matters. The biggest impact was in the year ended Oct. 28, 2000, which swung from a $67.9 million profit to a $951.2 million loss. The restatement lowered net income in some periods, and raised it in others. In all, Brocade shayed a total of $303 million in net income between fiscal 1999 and fiscal 2001, the SEC noted in its complaint.

In yesterday's filings and at the news conference, officials described in some detail how the alleged scheme worked. In one instance, according to the SEC complaint, Mr. Reyes interviewed a job candidate on Feb. 1, 2002, and told Ms. Jensen that day that the candidate would be hired and should be included in an options grant being backdated to Nov. 28, 2001. Ms. Jensen included the person and signed a backdated offer letter to the candidate, who was hired. When Brocade shares fell, according to the SEC, Mr. Reyes changed the grant date again, and Ms. Jensen directed preparation of a new, backdated offer letter.

Explaining the backdating's impact, Linda Thomsen, the SEC's enforcement director, said that in fiscal 2002, for instance, all of Brocade's employee grants were dated at monthly or quarterly low points in the stock price. Ms. Thomsen said the "scheme was blatant."

To facilitate the scheme, the SEC said, Ms. Jensen prepared false compensation-committee minutes purporting to show that Mr. Reyes -- the committee's sole member -- actually granted the options on the days they were dated. The SEC said Mr. Reyes and Ms. Jensen provided the phony documents to financial staffers so that they would record the options as having been granted at fair market value on the date of grant.

Officials also claim warning signs were ignored. For instance, they claimed, Mr. Canova received an email from an unidentified employee that described the options-granting process to another employee as "forging option paperwork and offer letters so he could get better-priced options." The SEC complaint alleges that Mr. Canova did not investigate or report the backdating or the falsified documents to Brocade's board.

Beyond options gains, Ms. Thomsen said, an executive also can benefit by selling stock at prices "inflated" because of false financial statements. Mr. Reyes sold some $380 million in Brocade shares during his tenure.

The SEC's complaint said Mr. Reyes's own options, which were granted by the company's board, not the one-man committee, also were backdated. But the agency's complaint doesn't explain who was responsible, or how the backdating occurred. Two 2001 grants to Mr. Reyes were backdated to the same dates as other employees' grants, the SEC said. One was dated in April and the other on Oct. 1, at the bottom of a deep trough in Brocade's share price after the Sept. 11 terrorist attacks.

Mr. Reyes never cashed in any of his options. Brocade's stock, after peaking in late 2000, declined in the larger tech collapse, and for years has traded at a fraction of its price during the boom.

Said Patrick D. Daugherty, a Detroit-based partner at the law firm Foley & Lardner, "The government has chosen a very good case to begin a crackdown or send a message. These are very ugly facts that are spelled out."
Still, the case may not be a slam dunk. Though there is strong documentary evidence of fraud, including emails and apparently forged meeting minutes, options backdating is a novel area of the law and it's unclear whether jurors will agree the charges, if proved, are worthy of prison time.

Brocade said in a statement that it had reserved $7 million for a proposed settlement with the SEC. The settlement amount, already accepted by SEC staff, is contingent upon approval by SEC commissioners, the company said.

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Online Today: See the text of government and defense statements on the Brocade case, and a scorecard of companies that have been identified as having potential options-dating issues, at WSJ.com/PerfectPayday.
EXHIBIT "M-1"
Statement of Paul S. Sarbanes
U.S. Senate Committee on Banking, Housing, and Urban Affairs
"Stock Options Backdating"
September, 06 2006

Thank you, Chairman Shelby, for holding today’s hearing on a subject matter of serious concern to investors, the practice of public companies improperly backdating stock options.

Federal securities laws are predicated in large part on public companies making full and fair disclosure. Investors rely on companies’ disclosures in their investment decisions and obviously they expect honest representations. If a company makes misleading or fraudulent statements, investors will lose confidence in their company’s accounting, internal controls and management. Regrettably, if enough companies engage in misconduct, investors will begin to question the integrity of the U.S. capital markets. Their reputation for integrity has been an important economic asset for the Nation.

In May 2005, Professor Erik Lie published research that found that returns on unscheduled stock option grants by a large number of companies were “abnormally high.” He concluded, “Unless executives possess an extraordinary ability to forecast the future market wide movements that drive these predicted returns, the results suggest that at least some of the awards are timed retroactively.” [Erik Lie, “On the Timing of CEO Stock Option Awards,” Management Science, May 2005, pp. 802-812]

Regulators are now investigating a large number of companies that may have awarded options retroactively, contrary to their stated policies.

Glass Lewis reports that over 120 companies have announced they are under regulatory investigation or are investigating themselves to determine whether they have improperly backdated stock options.

This issue has attracted broad public attention and concern:

- The New York Times noted, “Investors are getting a clearer view of what these executives were doing with their beloved options. It's not pretty.” [Gretchen Morgenson, “At the Options Buffet, Some Got a Bigger Helping,” July 23, 2006.]
The San Francisco Chronicle opined that "The real story is now stock options -- once a universally cherished benefit in Silicon Valley -- have led to executive abuse and erosion of the public trust." ["Shareholders' Poor Options," TSFC, July 27, 2006.]

USA Today observed that it serves "as yet another troubling example of how shareholders are being fleeced. It would also show how a benefit designed to attract, reward and retain talented employees is being perverted." ["... and outrageous options," USAT, May 31, 2006]

Unfortunately, it appears that improper backdating has been widespread and gone unregulated for many years. Even after the enactment of Sarbanes-Oxley and its two-day reporting requirement which curtailed the problem, backdating reportedly has continued where options reports were filed late, in other words did not comply with the statutory requirement.

The SEC and others have brought enforcement actions against former officers of companies. The SEC also, on August 11, 2006, published final rules that require more disclosure about options grants, particularly backdated options, and about springloading. Notably, the Commission received a record 23,244 public comments on this rule, showing a strong investor interest in the disclosure of executive compensation. The PCAOB has published a Staff Practice Alert touching on this issue.

I look forward to learning about the scope of the significant problem, what the regulators are doing to address it, and what more should be done to prevent future problems. I am particularly interested in whether the SEC needs more resources, for enforcement staff or otherwise, or more authority in order to address this issue.

I join in welcoming our distinguished witnesses, Chairman Cox, welcome back to the Committee. Chairman Olsen, I welcome you as Chairman of the Public Company Accounting Oversight Board, although you have testified here before on behalf of the Federal Reserve Board and the American Bankers Association and have served on the Committee’s staff.

The second panel includes Lynn Turner, former Chief Accountant of the Securities and Exchange Committee, who testified before the Committee in 2002 about auditor independence and regulation, University of Iowa Professor Erik Lie, Kurt Schact of the CFA Institute and Russell Read of CalPERS.

Once again, thank you Mr. Chairman for your leadership on the expensing of stock options and now for conducting this important oversight hearing on the backdating and springloading of stock options.
EXHIBIT “M-2”
Thank you for inviting me to testify today about options backdating. This issue is one of intense public interest because it strikes at the heart of the relationship among a public company’s management, its directors, and its shareholders. I appreciate the opportunity to explain the Commission’s initiatives to deal with abuses involving the backdating of options.

I am especially pleased to testify together with Chairman Mark Olson of the Public Company Accounting Oversight Board. I will let Chairman Olson speak to the steps the PCAOB is taking to address these issues from the auditing regulator’s perspective, but I’d like to assure the Committee, and the public, that the Commission is working in close cooperation with the PCAOB in this important area.

There are many variations on the backdating theme. But here is a typical example of what some companies did: They granted an “in-the-money” option—that is, an option with an exercise price lower than that day’s market price. They did this by misrepresenting the date of the option grant, to make it appear that the grant was made on an earlier date when the market value was lower. That, of course, is what is meant by abusive “backdating” in today’s parlance.

The purpose of disguising an in-the-money option through backdating is to allow the person who gets the option grant to realize larger potential gains—without the company having to show it as compensation on the financial statements.

Rather obviously, this fact pattern results in a violation of the SEC’s disclosure rules, a violation of accounting rules, and also a violation of the tax laws.

The SEC has been after the problem of abusive options backdating for several years. As a preliminary step in explaining the Commission’s response to the problem of fraudulent options backdating, it would be useful to put the whole topic of options compensation into some perspective.

As you know, during the last year the Commission has been intensely focused on the quality of disclosure of executive compensation. Very recently, we enacted new rules that will require, beginning with the next proxy season, the full disclosure of all aspects of executive and director pay and benefits. A key component of that disclosure will be
compensation in the form of stock options, which has been a fast growing portion of executive pay since the early 1990s.

Under the new SEC rules, all of an executive's compensation will now be totaled into one number, so that it can be compared easily from person to person, company to company, and industry to industry. The new rules also require detailed disclosure of compensation in the form of stock options, which will show whether a company has backdated options, and if so, why. The purpose of the new executive compensation rules is to make the CEO’s pay understandable to the shareholders who own the company.

Of course, no new SEC rules would be necessary to make executive pay transparent, if executives were all paid in the form of salary. But beyond the obvious fact that the income tax code discriminates in favor of non-salary compensation that can be taxed as capital gains, one of the most significant reasons that non-salary forms of compensation have ballooned since the early 1990s is the $1 million legislative cap on salaries for certain top public company executives that was added to the Internal Revenue Code in 1993.

As a Member of Congress at the time, I well remember that the stated purpose was to control the rate of growth in CEO pay. With complete hindsight, we can now all agree that this purpose was not achieved. Indeed, this tax law change deserves pride of place in the Museum of Unintended Consequences.

There are other accounting and tax reasons, as well, that stock options over the years were increasingly included in the compensation packages of executives and non-executives.

Beginning in 1972, the accounting rule was that employee stock options wouldn’t have to be shown as an expense on the income statement—so long as the terms were fixed when the option was granted, and so long as the exercise price was equal to the market price on that day. Indeed, no expense would ever need to be recorded in the financial statements for fixed options that weren’t granted in-the-money.

In addition to this favorable accounting treatment, there was a tax benefit. The million-dollar cap on the tax deductibility of executive compensation, which I mentioned earlier, doesn’t apply to options granted at fair market value. So for companies that wanted or needed to pay compensation in excess of $1 million per year, the tax code outlawed deducting it if it was paid in a straightforward way through salary, but permitted a deduction if the compensation was paid through at-the-money options.

And of course there were other reasons, many of them good ones with solid economic rationales, that companies wanted to use options as a form of compensation. For example, a properly-structured option plan can be useful in more closely aligning the incentives of shareholders and managers. And for growth companies, the use of stock options as compensation offers a way to conserve resources while attracting top-flight talent in highly competitive markets.
All of these factors have contributed to the now-widespread use of stock options as compensation. But just as option compensation increased, so did the potential for abuse. And Congress deserves credit for taking preemptive action that we now know was critical to stopping the spread of the backdating contagion.

Four years ago, in 2002, the Sarbanes-Oxley Act very presciently tightened up on the reporting of stock option grants. Before Sarbanes-Oxley, officers and directors didn't have to disclose their receipt of stock option grants until after the end of the fiscal year in which the transaction took place. So a grant in January might not have to be disclosed until more than a year later. SOX changed that, by requiring real-time disclosure of option grants. And in August 2002, shortly after the law was signed, the SEC issued rules requiring that officers and directors disclose any option grants within two business days.

Not only must option grants now be reported within two business days, but this information was among the first required to be filed electronically using interactive data. Thanks to this new data-tagging technology, the public now has almost instant access to information about stock option grants.

The following year, in 2003, the SEC took another important step that has helped increase the transparency of public company options plans. The Commission approved changes to the listing standards of the New York Stock Exchange and the Nasdaq Stock Market that for the first time required shareholder approval of almost all equity compensation plans. Companies have to publicly disclose the material terms of their stock option plans in order to obtain shareholder approval.

Very importantly, the required disclosures include the terms on which options will be granted. And companies must tell their shareholders whether the plan permits options to be granted with an exercise price that's less than the market value on the date of grant.

Then, in December 2004, the FASB issued Statement of Financial Accounting Standard 123R, which effectively eliminated the accounting advantage that had previously been given to stock options issued at-the-money. Since this new accounting rule took effect, all stock options granted to employees have to be recorded as an expense in the financial statements, whether or not the exercise price is at fair market value. This rule is nearly fully phased in.

Most recently, in January of this year, the SEC proposed that public companies be required to more thoroughly disclose their awards of in-the-money options to certain executives. The Commission also proposed that companies be required to disclose the fair value of the option on the grant date, as determined under the new accounting rules. The Commission adopted final rules on these subjects on July 26, 2006. As a result, in the next proxy season beginning in the spring, all public companies will now report this information in clear, easy to understand tabular presentations.
The tables will include:

- The grant date fair value under FAS 123R (which is aggregated in the total compensation amount that is shown for each named executive officer);

- The FAS 123R grant date;

- The closing market price on the grant date if it is greater than the exercise price of the option; and

- The date the compensation committee or full board of directors took action to grant the option, if that date is different than the grant date.

Because the dates and numbers often don’t tell the whole story, companies will also be required to discuss the policies and goals of their compensation programs—in plain English. The reports to investors will describe whether, and if so how, a company has engaged (or might engage in the future) in backdating or any of the many variations on that theme concerning the timing and pricing of options. For example, if a company has a plan to issue option grants in coordination with the release of material non-public information, that will now be clearly described.

The Commission will continue to avail itself of every opportunity to clarify the rules and procedures for options issuance going forward. To that end, you can expect that the Office of the Chief Accountant will soon issue further public guidance on the accounting issues surrounding backdating.

So, to recap, here is what has been done by way of prophylactic rules to eliminate the opportunities for abusive backdating. First, Sarbanes-Oxley has closed the disclosure loophole that permitted months and sometimes more than a year to elapse before option grants had to be reported. Second, a new accounting rule—FAS 123R—has eliminated the accounting benefit of granting at-the-money options. And third, the SEC’s brand new executive compensation rules now require a complete quantitative and narrative disclosure of a company’s executive compensation plans and goals. That enhanced disclosure will make it clear whenever options are being backdated, and it will require an explanation of the reasons. These new rules will soon be complemented by additional accounting guidance on these subjects.

Each of these steps by itself is an important contribution to preventing backdating abuse. In combination, they have effectively slammed the door shut on the easy opportunities to get away with secretive options grants. That’s why almost all of the stock option abuses our Enforcement Division has uncovered started in periods prior to these reforms.

But while these accounting and disclosure rules changes have made it easier to detect and punish backdating abuses going forward, uncovering the problems from prior years has been quite a challenge.
A few years ago, the SEC began working with academics to decipher market data that provided the first clues something fishy was going on. One of the academics with whom the SEC worked was Erik Lie of the University of Iowa, who subsequently published a paper in 2005 that showed compelling circumstantial evidence of backdating.

Dr. Lie's data showed that before 2003, a surprising number of companies seemed to have had an uncanny ability to choose grant dates that coincided with low stock prices. (In a follow-up paper this year, co-authored with Dr. Randall Heron of Indiana University, Dr. Lie demonstrated that this problem has greatly diminished since 2002, when the Sarbanes-Oxley Act shortened the time for reporting option grants to two business days.)

With a fair amount of detective work, and with the aid of economic research conducted by the SEC's Office of Economic Analysis, the Commission succeeded in turning what had begun as mere evidentiary threads into solid leads. Eventually, some of the evidence we began turning up was so compelling that several U.S. Attorneys took a criminal interest. Over the past several years, our inventory of backdating and related investigations has grown substantially. And beginning three years ago, the SEC has brought several enforcement actions against companies and individuals for fraudulent option practices.

For example, in 2003, the Commission charged Peregrine Systems, Inc. with financial fraud for failing to record any expense for compensation when it issued incentive stock options. The SEC's complaint alleged that at each quarterly board meeting, the company's directors would approve a total number of options for employees. The company would then allocate the options to the employees during the quarter. But the options wouldn't be priced until the day after the next quarterly Board meeting. On that day, the company looked back at the market price of its stock between the two quarterly Board meetings, and picked the lowest price. That turned the options into in-the-money grants. But even though accounting rules required that they then be recorded as compensation expense; the company didn't do that. As a result, Peregrine understated its expenses by approximately $90 million.

The following year, in 2004, the SEC brought a case involving the manipulation not of option grants, but of exercise dates. Our complaint charged that Symbol Technologies, Inc. and its former general counsel fudged option exercise dates so that senior executives could profit unfairly at the company's expense. Rather than use the actual exercise date as defined by the company's option plans, the general counsel picked the most advantageous date from a 30-day "look-back" period in order to come up with a lower exercise price. This was done without board approval or public disclosure. The SEC charged that to create the false appearance that these exercises had actually occurred on the chosen dates, the company's general counsel had instructed his staff to backdate the relevant documents, and to substitute phony exercise dates on the forms the executives used to report their option exercises to the SEC and the public. The result, according to the complaint, was a serious misstatement of the company's stock option expenses.
When the company subsequently restated its improper accounting, the cumulative net increase in reported stock option expenses was $229 million. The amount would undoubtedly have been higher had it not been for the passage of the Sarbanes-Oxley Act. Thanks to the Act’s new two-day deadline for reporting options transactions by officers and its prohibition on company loans to officers and directors, the company and its general counsel had put a halt to the “look-backs” because the law had rendered the practice unfeasible.

While the alleged manipulations of option grants and exercises in these two cases were part of larger accounting fraud charges, two more recent cases have focused solely on option practices. These are the Brocade and Comverse actions that the SEC filed in July and August of this year. The executives charged in these cases are contesting the SEC’s allegations.

In July, the SEC filed a civil fraud action against three former executives of Brocade Communications Systems, alleging that the former CEO and the former Vice President of Human Resources routinely backdated stock option grants to give employees favorably priced options without recording the necessary compensation expenses. Specifically, the SEC’s complaint alleges that the CEO caused Brocade to grant in-the-money options to both new and current employees between 2000 and 2004, and then backdated documents to make it appear that the options were at-the-money when granted. This had the effect of concealing millions of dollars in expenses from investors.

The complaint alleges that the CEO repeatedly used hindsight to select a date with a lower stock price from the recent past as the purported option grant date, and that, to facilitate the scheme, the Human Resources executive created, or directed others to create, false paperwork making it appear that the options had been granted on the earlier date. The complaint alleged that, in some instances, employment offer letters and compensation committee minutes were falsified to suggest that options had been granted to employees before they had even been hired by the company.

The SEC’s complaint also charged Brocade’s former CFO, alleging that he learned of the backdating after joining the company but took no action to correct or halt the practice and instead signed Brocade’s SEC filings. When these stock option practices surfaced, Brocade was required to restate and revise its financial statements for six fiscal years, from 1999 through 2004. The scheme resulted in the inflation of Brocade’s net income by as much as $1 billion in the year 2000 alone. Simultaneously with the filing of the SEC’s complaint, the U.S. Attorney’s Office for the Northern District of California separately filed criminal charges against the former CEO and the former Vice President of Human Resources for the same misconduct.

In the second recent case, the Commission filed a civil fraud complaint last month against three former senior executives of Comverse Technology, Inc., alleging that they engaged in a decade-long fraudulent scheme to grant undisclosed, in-the-money options to themselves and to others by backdating stock option grants to coincide with historically low closing prices of Comverse common stock.
The complaint alleges that from 1991 to 2002, Converse's founder and former Chairman and CEO repeatedly used hindsight to select a date when the closing price of Converse's common stock was at or near a quarterly or annual low. According to the complaint, the CEO then communicated this date and closing price to Converse's former general counsel who, with the CEO's knowledge, created company records that falsely indicated that a committee of Converse's board of directors had actually approved the option grant on the date the CEO had picked.

The complaint also alleges that Converse's former CFO joined the scheme no later than 1998, and assisted in selecting backdated grant dates. It is alleged that each of the three defendants realized actual illicit gains from the backdating when they sold stock they acquired from exercises of backdated options, including at least $6 million by the CEO alone. In addition, the complaint alleges that the former CEO and CFO created a slush fund of backdated options between 1999 and 2002 by causing options to be granted to fictitious employees and, later, used these options to recruit and retain key personnel.

Converse has publicly announced that it expects to restate historical financial results for multiple years in order to record material charges for option-related compensation expenses. Simultaneously with the filing of the SEC's complaint, the U.S. Attorney's Office for the Eastern District of New York unsealed a criminal complaint charging these three executives with conspiracy to violate the antifraud provisions of the federal securities laws, wire fraud, and mail fraud by engaging in the same scheme.

These cases demonstrate some of the variations on the basic theme of fraudulent backdating that the Commission has uncovered. They involve backdated option grants that are more profitable to recipients; backdated option exercises that reduce recipients' taxes at the expense of shareholders; options granted to top executives; and options granted to rank and file employees. They involve actual personal gain to wrongdoers, and real harm to companies that failed to properly account for the options practices.

Unfortunately, these cases that I've used as illustrations are not the only matters the SEC has under investigation. The SEC's Division of Enforcement is currently investigating over 100 companies concerning possible fraudulent reporting of stock option grants. The companies are located throughout the country, and include Fortune 500 companies as well as smaller cap issuers. They span multiple industry sectors.

You should not expect that all of these investigations will result in enforcement proceedings. At the same time, we have to expect other enforcement actions will be forthcoming in the future.

The SEC's Enforcement staff is sharing information related to its investigations with other law enforcement and regulatory authorities as warranted and appropriate, including the Department of Justice, the President's Corporate Fraud Task Force, U.S. Attorney's offices around the country, the Federal Bureau of Investigation, and the Internal Revenue Service.
In our rulemaking, our provision of accounting and final regulatory guidance, and our enforcement programs, the SEC has been and will remain vigilant in the battle against fraudulent options backdating. The agency is grateful for the opportunity to provide you with this update on a very important subject. I am happy to take any questions you may have.
EXHIBIT “M-3”
Testimony Concerning
Certain Issues Related to
Companies' Stock Option Granting Practices

Mark W. Olson
Chairman
Public Company Accounting Oversight Board

Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

September 6, 2006
Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee:

I am pleased to appear today on behalf of the Public Company Accounting Oversight Board to discuss the PCAOB's response to concerns relating to certain stock option granting practices.

The PCAOB oversees the auditors of public companies, in order to protect the interests of the investing public in the preparation of informative, accurate and independent audit reports on public company financial statements. The PCAOB does not regulate accounting or disclosures by public companies; rather, the PCAOB's role is to enhance the quality of the audits of such financial statements. Simply put, the PCAOB's job is to improve the quality and reliability of public company audits, so that investors can have more confidence in audited financial statements.

The Board has a variety of tools with which to promote improved audit quality. While those tools include meaningful enforcement and disciplinary authority – important authority backing up all of our other authority – the Board has focused on implementing a supervisory model of regulation intended to focus firms on the need for high quality auditing, by helping them see where they are falling short and providing feedback and guidance that facilitates their efforts to improve. The PCAOB's approach to the audit issues that arise in connection with companies' stock option granting practices is an example of the PCAOB's emphasis on real-time improvements in audit quality.
I. Stock Option Granting Practices Have Raised Concerns About Companies' Accounting for and Disclosure of Compensation Costs.

Before describing the PCAOB's response to concerns about some companies' stock option granting practices, I will briefly describe the history of these concerns and certain regulatory changes that appear to have reduced the opportunity and incentive for some of the practices at issue.

A. Employee Stock Options Can Be a Useful Tool, but Concerns Have Arisen Whether Companies Have Properly Disclosed Their True Costs.

As we all know, many companies issue stock options as a form of compensation and to give employees vested interests in improving their companies' performance and share prices. Such options usually give employees the right to buy shares in the future, at the price of the stock on the date of the grant. The higher the share price rises relative to the exercise price, the more valuable the options are. Well managed, stock options can be a useful and appropriate tool to attract and retain employees.

Companies' financial statements, of course, must account for and disclose options consistent with applicable accounting and regulatory requirements, and recently concerns have arisen that some may not have done so. More than 120 companies have announced they are involved in civil or criminal investigations, or internal reviews, of possible problems in the way they have granted, accounted for and disclosed stock option compensation to senior executives and other employees. Academic studies have long noted suspiciously favorable patterns related to the timing of option grants. Those patterns were largely attributed to companies planning option grants in advance.
of significant releases of information, until a 2005 study by University of Iowa researcher's Erik Lie, who I understand will discuss his work in the second panel of this hearing.¹ That study suggested that the favorable granting patterns could be attributable to companies having retroactively assigned option grant dates on dates their stocks hit relative lows, when the options were in fact granted weeks or months later.

B. Changes in Regulatory Requirements Appear to Have Reduced the Incidence of Suspiciously-timed Option Grants.

While the extent of the problems arising from backdating and other stock option granting practices is not yet clear, two significant changes in the disclosure and accounting for stock option grants in recent years – the first initiated by, and the second supported by, this Committee – seem to have significantly reduced companies' opportunity and incentive to backdate grants.

First, the Sarbanes-Oxley Act appears to have significantly reduced the incidence of backdated option grants. Specifically, the SEC's rules implementing Section 403 of the Act now require public company officers and directors to report their receipt of stock options within two days of the grant.² Previously, such persons were generally not required to report option grants until 45 days after the fiscal year in which they were received.³ Given the new filing requirement, the ability to backdate option grants to coincide with low stock prices is greatly curtailed. Indeed, subsequent research has shown that, following the change, when company insiders reported

options within the new deadline, there was little to no pattern of abnormal share price increases soon afterward.4

Second, accounting standards for employee stock options have also gone through several changes over the last few years. Historically, the applicable accounting standard – found in Accounting Principles Board Opinion No. 25 – required companies to record, as compensation cost, the amount, if any, by which the price of an employee stock option exceeded the market price on the date of the grant.5 Compensation expenses associated with such “in-the-money” stock options was required to be reported as incurred in the period or periods in which the employee performed services

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2 See SEC Release No. 34-46421, Ownership Reports and Trading by Officers, Directors and Principal Security Holders (August 27, 2002), available at http://www.sec.gov/rules/final/34-46421.htm. Section 403 of the Sarbanes-Oxley Act required certain company insiders to file reports of certain transactions in the securities of their companies within two days of the transaction. In addition, it required such reports to be filed electronically and available on a public, SEC Web site as well as on the company’s Web site if it maintains one.

3 Under Section 16 of the Securities Exchange Act of 1934, and the SEC’s implementing rules, directors, officers and certain others are required to report transactions and holdings involving their companies’ securities, including the receipt of employee stock options. Until August 29, 2002, stock options awarded under most employee stock purchase and other benefit plans were required to be reported (on the SEC’s Form 5) within 45 days after the end of the fiscal year in which they were granted. In its rule implementing Section 403 of the Sarbanes-Oxley Act, the SEC required certain transactions that were formerly reportable annually on Form 5, such as option grants, to be reported, like other insider transactions, on Form 4 within Section 403’s new two-day deadline.

4 That research also shows that the previously identified pattern of stock prices rising shortly after grant dates has continued for those companies whose insiders have not complied with the two-day requirement. See Heron, R. and Lie, E., “Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?” forthcoming in Journal of Financial Economics, available at http://www.biz.uiowa.edu/faculty/elie/Grants-JFE.pdf.

5 See Accounting Principles Board Opinion No. 25. Accounting Principles Board Opinions were promulgated by the American Institute of Certified Public Accountants until 1973, when the Financial Accounting Standards Board was established. At that time, the FASB adopted outstanding APB Opinions, as amended, and over time has superseded them.
for the option, which could extend for years after the option grant.\footnote{APB Opinion No. 25, para. 12.} As a result, failure to account properly for in-the-money options could affect several financial periods.

APB Opinion No. 25 permitted companies not to record any cost, however, when employee stock options were granted at a price equal to or greater than the market price on the date of the grant. APB Opinion No. 25 thus discouraged companies from granting options at less than the prevailing market price, although such discounted options could be more lucrative for recipients. Some companies may have attempted to have it both ways, though, by granting options at prices below market on the date of the grant but treating them for accounting and tax purposes as if they were granted on a date when market prices were lower.

In 1994, the Financial Accounting Standards Board adopted Statement of Financial Accounting Standards No. 123, which encouraged companies to report the cost of stock option grants to employees at their fair value, but permitted them to continue to rely on APB Opinion No. 25, so long as they disclosed what the compensation cost would have been had they recorded such options at their fair value.\footnote{See Statement of Financial Accounting Standards No. 123, \textit{Share-Based Payment}, available at http://www.fasb.org/pdf/fas123.pdf.} Finally, in 2004, the FASB eliminated APB Opinion No. 25 and, beginning with financial statements for annual periods starting after June 15, 2005, required companies to
account for employee stock options at their fair value, regardless of any difference between an option's exercise price and the market price at the time of grant.\(^8\)


Although much of the conduct currently under review appears to predate the Sarbanes-Oxley Act, errors related to such conduct may affect current period financial statements if employee performance related to past option grants continues into the present. That is, if an employee is still earning an option through performance (e.g., the option has not vested yet) then any compensation cost associated with the option may be allocable to the current financial period. In addition, new revelations of such conduct may trigger current auditor obligations with respect to past financial periods.

As the prevalence of problems in dating of stock option grants became clear, the PCAOB considered the implications of such problems for audits, and developed a strategy to draw those issues to auditors' attention so that they can address them in this year's audits. Specifically, the PCAOB reviewed patterns in option granting practices identified in available research, accounting firms' existing guidance to their auditors related to option granting practices, and auditing, accounting and regulatory requirements that have a bearing on audits of stock option grants. In addition, the Board discussed issues related to the timing of stock option grants at the June 2006

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public meeting of its Standing Advisory Group.\textsuperscript{9} With the encouragement of members of this advisory group, these efforts led to an Audit Practice Alert publicly issued by the Board’s staff on July 28, and disseminated electronically to the more than 1,600 public accounting firms registered with the PCAOB. This tool allowed the PCAOB to provide real-time guidance as auditors begin a new audit season, without adding to the volume or complexity of the body of existing standards.

I have attached a copy of this Alert as Exhibit A. The Alert focuses auditors on several considerations related to evaluating and addressing in their audits the risk that stock option granting practices may have led to material misstatement of financial statements. In doing so, the Alert identifies existing standards that could bear on their work and applies them to the issues that have been raised regarding companies’ stock option granting practices; the Alert does not establish new requirements.

Specifically, the Alert tells auditors that, in audits currently underway or to be performed in the future, they should use certain information that existing standards direct them to acquire, in order to assess the nature and potential magnitude of risks associated with their audit clients’ stock option granting practices. The Alert also emphasizes that auditors must use professional judgment in making this assessment and in determining appropriate procedures to address any identified risks. In addition, the Alert reminds auditors of several procedural considerations, such as how they

\textsuperscript{9} The Board convened its Standing Advisory Group pursuant to Section 103(a)(4) of the Sarbanes-Oxley Act. The Group consists of a select group of experts in auditing and financial reporting, including representatives of investors, accountants, and public companies and meets three times a year to advise the Board on its standards-setting responsibilities.
should approach requests for consents to use past audit opinions, including situations in which they are no longer the auditor of record. The Alert also describes circumstances in which existing standards require auditors to reconsider past audit opinions.

As the Alert points out, in assessing the risk of material misstatement of financial statements, an auditor should consider whether the company accounted for options that are still outstanding under APB Opinion No. 25. If so, and if a company granted options at a price that was lower than the market price on the true grant date, then the auditor should consider whether compensation costs were materially understated (and whether additional disclosures should have been made) in the periods of the recipient-employee’s performance, including the current period. The Alert also instructs the auditor to consider the effect of any errors in measuring compensation on the effectiveness of the company’s internal control over financial reporting. Finally, the Alert reminds auditors that errors in reported option compensation may have material tax implications for companies and may result in material contingent obligations, including those due to pending legal and regulatory matters.

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10 The Internal Revenue Code limits the deduction public companies may take for compensation paid to certain executive officers to $1 million, but it excludes from this limit compensation that is performance-based. See Internal Revenue Code Section 162(m). Stock option compensation may be treated as performance-based when the exercise price is equal to or more than the grant date’s market price. If, on the other hand, the option provides for a discounted exercise price, it counts toward, and is subject to tax if it exceeds, the deduction limit. Companies that may have granted stock options at an exercise price that differs from the market price on the grant date, may have a tax liability, and potentially penalties, for past taxes due. If material, auditors should confirm that these items are recorded and reported in the financial statements.
In closing, the Board appreciates the opportunity to describe how it has approached concerns about companies’ accounting for employee stock options. Alerting auditors to practices and trends that may be relevant to their ongoing audits is a critical part of the PCAOB’s approach to oversight. The Board’s goal is to help auditors identify and address problems in financial reporting in order to protect investors’ interests in high-quality and reliable audits. The PCAOB’s work in the area of auditing employee stock option grants is an important step toward this goal.

I would be pleased to answer any questions.
STAFF AUDIT PRACTICE ALERT NO. 1

MATTERS RELATED TO TIMING AND ACCOUNTING FOR OPTION GRANTS

July 28, 2006

Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Recent reports and disclosures about issuer practices related to the granting of stock options, including the "backdating" of such grants, indicate that some issuers' actual practices in granting options might not have been consistent with the manner in which these transactions were initially recorded and disclosed. Some issuers have announced restatements of previously issued financial statements as a result of these practices. In addition, some of these practices could result in legal and other contingencies that may require recognition of additional expense or disclosure in financial statements.

This practice alert advises auditors that these practices may have implications for audits of financial statements or of internal control over financial reporting ("ICFR") and discusses factors that may be relevant in assessing the risks related to these matters.

Background

The recorded value of a stock option depends, in part, on the market price of the underlying stock on the date that the option is granted and the exercise price specified in the option. Some issuers may have granted options with exercise prices that are less than the market price of the underlying stock on the date of
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grant. These options are sometimes referred to as “discounted” or “in-the-money” options. Where discounted options were granted and an issuer failed to properly consider this condition in its original accounting for the option, errors in recording compensation cost, among other effects, may have resulted. These errors may cause an issuer’s financial statements, including related disclosures, to be materially misstated.1/

While this alert does not attempt to describe all of the variations in circumstances that may result in the issuance of discounted options, a range of practices appears to be involved, including --

- The application of provisions in option plans that allow for:
  - the selection of exercise prices based on market prices on dates earlier than the grant date, or
  - the award of options that allow the option holder to obtain an exercise price equal to the lower of the market price of the stock at the grant date or during a specified period of time subsequent to the grant date.

- Preparation, or subsequent modification, of option documentation for purposes of indicating a lower exercise price than the market price at the actual grant date.

- Treating a date as the grant date when, in fact, all of the prerequisites to a grant had not yet occurred.

Available information suggests that the incidence of these and similar practices may have substantially decreased after the implementation of the shortened filing deadline for reports of option grants specified by Section 403 of the Sarbanes-Oxley Act of 2002. In August 2002, the Securities and Exchange Commission (“SEC”) implemented this requirement by requiring the reporting of an option grant on Form 4 within two days of the date of grant. However, periods subsequent to the grant of an option may also be affected by improper

1/ In addition, academic research has suggested the possibility that some issuers may have purposefully granted options immediately before the release of information that the issuer believed would be favorable to its share price. While these practices may not result in the granting of discounted options, they may create legal or reputational risks and raise concerns about the issuer’s control environment.
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accounting for a grant because option cost is generally expensed over the period during which the issuer receives the related services, most commonly its vesting period.

Matters for auditor consideration

Auditors planning or performing an audit should be alert to the risk that the issuer may not have properly accounted for stock option grants and, as a result, may have materially misstated its financial statements or may have deficiencies in its ICFR. For audits currently underway or to be performed in the future, the auditor should acquire sufficient information to allow him or her to assess the nature and potential magnitude of these risks. An auditor must use professional judgment in making these assessments and in determining whether to apply additional procedures in response.

In making these judgments, auditors should be mindful of the following --

Applicable financial accounting standards. Financial Accounting Standards Board Statement of Financial Accounting Standards ("SFAS") No. 123 R (revised 2004), Share-Based Payment, applies to issuer reporting periods beginning after June 15, 2005 (December 15, 2005 for small business issuers). Accounting for options was, however, previously governed by other accounting standards and related interpretations, specifically Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and SFAS No. 123, Accounting for Stock-Based Compensation. If an auditor determines that it is necessary to consider the accounting for option grants and related disclosures in financial statements of a prior period, the auditor should take care to determine the applicable generally accepted accounting principles in effect in those periods and to consider the specific risks associated with these principles.

- Accounting for discounted options. For periods in which an issuer used the provisions of APB 25 to determine compensation cost related to stock options, the issuer may have been required to record additional compensation cost equal to the difference in the exercise price and the market price at the measurement date (as defined in APB 25). In periods in which the issuer has recorded option compensation cost using the fair value method as allowed by SFAS No. 123, or as required by SFAS No. 123 R (revised 2004), the impact on the calculated fair value of options of using an incorrect date as the grant date would depend on the nature and
matters related to timing and accounting for option grants

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magnitude of changes in conditions that affect option valuation between the incorrect date used and the actual grant date. In all cases, the compensation cost of options should be recognized over the period benefited by the services of the option holder.

- Accounting for variable plans. For periods in which an issuer used the provisions of APB 25 to determine compensation cost related to stock options, an option with terms allowing a modification of the exercise price, or whose exercise price was modified subsequent to the grant date may require variable plan accounting. Variable option accounting requires that compensation cost be recorded from period to period based on the variation in current market prices. In periods in which the issuer records option compensation cost using the fair value method as allowed by SFAS No. 123, or as required by SFAS No. 123 R, the right to a lower exercise price may constitute an additional component of value of the option that should be considered at the grant date. In all cases, the cost of options should be recognized over the period benefited by the services of the option holder.

- Accounting for contingencies. If the consequences of the issuer's practices for stock option grants or its accounting for, and disclosure of, option grants result in legal or other contingencies, the application of SFAS No. 5, Accounting for Contingencies, may require that the issuer record additional cost or make additional disclosures in financial statements.

- Accounting for tax effects. The grant of discounted stock options may affect the issuer's ability to deduct expenses related to these options for income tax purposes, thereby affecting the issuer's cash flows and the accuracy of the related accounting for the tax effects of options.

Consideration of materiality. In evaluating materiality, auditors should remember that paragraph .11 of AU sec. 312, Audit Risk and Materiality in Conducting an Audit, and SEC Staff Accounting Bulletin: No. 99 – Materiality emphasize that both quantitative and qualitative considerations must be assessed. Qualitatively small misstatements may be material when they relate to unlawful acts or to actions by an issuer that could lead to a material contingent liability. In all cases, auditors should evaluate the adequacy of related issuer disclosures.
Possible illegal acts. Auditors who become aware that an illegal act may have occurred must comply with the applicable requirements of AU section ("AU sec.") 317, Illegal Acts, and Section 10A of the Securities Exchange Act of 1934. Section 10A, among other things, requires a registered public accounting firm to take certain actions if it "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred...." If it is likely that an illegal act has occurred, the registered public accounting firm must "determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages." The registered public accounting firm must also inform the appropriate level of management and assure that the audit committee is adequately informed "unless the illegal act is clearly inconsequential." The auditor may, depending on the circumstances, also need to take additional steps required under Section 10A if the issuer does not take timely and appropriate remedial actions with respect to the illegal act.

A. Effects of options-related matters on planned or ongoing audits

In planning and performing an audit of financial statements and ICFR, the auditor should assess the nature and potential magnitude of risks associated with the granting of stock options and perform procedures to appropriately address those risks. The following factors are relevant to accomplishing these objectives --

- Assessment of the potential magnitude of risks of misstatement of financial statements and deficiencies in ICFR related to option granting practices. This assessment should include consideration of possible indicators of risk related to option grants, including, where appropriate:
  - The status and results of any investigations relating to the timing of options grants conducted by the issuer or by regulatory or legal authorities.
  - The results of direct inquiries of members of the issuer's management and its board of directors that should have knowledge of matters related to the granting and accounting for stock options.
  - Public information related to the timing of options grants by the issuer.
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- The terms and conditions of plans or policies under which options are granted; in particular, terms that allow exercise prices that are not equal to the market price on the date of grant or that delegate authority for option grants to management. In these situations, auditors should also consider whether issuers have other policies that adequately control the related risks.

- Patterns of transactions or conditions that may indicate higher levels of inherent risk in the period under audit. Such patterns or conditions may include levels of option grants that are very high in relation to shares outstanding, situations in which option-based compensation is a large component of executive compensation, highly variable grant dates, patterns of significant increases in stock prices following option grants, or high levels of stock-price volatility.

In planning and performing audits, auditors should appropriately address the assessed level of risk, if any, related to option granting practices. Specifically:

- In addition to the general planning considerations for financial statement audits identified in AU sec. 311, Planning and Supervision, the auditor should consider:
  - The implications of any identified or indicated fraudulent or illegal acts related to option grants to assessed risks of fraud (AU sec. 312.07 and AU sec. 316, Consideration of Fraud in a Financial Statement Audit); the potential for illegal acts (AU sec. 317, Illegal Acts by Clients); or the assessment of an issuer's internal controls (AU sec. 319, Internal Control in a Financial Statement Audit).
  - The scope of procedures applied to assess the potential for fraud (AU sec. 316) and illegal acts (AU sec. 317).

- The nature, timing, and extent of audit procedures applied to elements of the financial statements affected by the issuance of options. In particular, this assessment should include consideration of:
  - The need for specific management representations related to these matters (AU sec. 333, Management Representations) and the nature of matters included in inquiries of lawyers (AU sec. 337, Inquiry of a Client's Lawyer).
Where applicable, the result of tests of internal controls over the granting, recording, and reporting of option grants.

The need, based on the auditor's risk assessment, for additional specific auditing procedures related to the granting of stock options.

For integrated audits performed as described in PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements ("AS No. 2"), the auditor should consider the implications of identified or potential accounting and legal risks related to options in planning, performing, and reporting on audits of ICFR. In addition, as discussed in paragraphs 145-158 of AS No. 2, the results of the audit of ICFR should be considered in connection with the related financial statement audit.

B. Auditor involvement in registration statements

In cases where an auditor is requested to consent to the inclusion of his or her report, including a report on ICFR, in a registration statement under the Securities Act of 1933, AU sec.711, Filings Under Federal Securities Statutes, provides that the auditor should perform certain procedures prior to issuing such a consent.2

- Paragraph .10 of AU sec. 711 provides that an auditor should perform certain procedures with respect to events subsequent to the date of the audit opinion up to the effective date of the registration statement (or as close thereto as is reasonable and practical under the circumstances). These procedures include inquiry of responsible officials and employees of the issuer and obtaining written representations from them about whether events have occurred subsequent to the date of the auditor's report that have a material effect on the financial statements or that should be disclosed in order to keep the financial statements from being misleading. The auditor should consider performing inquiries and obtaining representations specifically related to the granting and recording of option grants.

- Paragraph .11 of AU sec. 711 provides that a predecessor auditor that has been requested to consent to the inclusion of his or her report on prior-

2 Under Paragraph 198 of AS 2, the auditor should apply AU sec. 711 when the auditor's report on management's assessment of ICFR is included in filings under federal securities statutes.
period financial statements in a registration statement should obtain written representations from the successor auditor regarding whether the successor auditor's audit and procedures with respect to subsequent events revealed any matters that might have a material effect on the financial statements reported on by the predecessor auditor or that would require disclosure in the notes to those financial statements. If the successor auditor becomes aware of information that leads him or her to believe that financial statements reported on by the predecessor auditor may require revision, the successor auditor should apply paragraphs .21 and .22 of AU sec. 315.3

- If either the successor or predecessor auditor discovers subsequent events that require adjustment or disclosure in the financial statements or becomes aware of facts that may have existed at the date of his or her report and might have affected the report had he or she been aware of them, the auditor should take the actions described in paragraph .12 of AU sec. 711. In addition, where the auditor concludes that unaudited financial statements or unaudited interim financial information presented, or incorporated by reference, in a registration statement are not in conformity with generally accepted accounting principles, he or she should take the actions described in paragraph .13 of AU sec. 711.

C. Effects of option-related matters on previously issued opinions

If an auditor becomes aware of information that relates to financial statements previously reported on by the auditor, but which was not known to him or her at the date of the report, and which is of such a nature and from such a source that he or she would have investigated it had it come to his or her attention during the course of the audit, he or she should take the actions described in AU sec. 561, Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.

3 In cases in which a predecessor auditor reissues his or her report on financial statements included in a filing under the Securities Exchange Act of 1934, the predecessor auditor should follow the directives in paragraphs .71 through .73 of AU sec. 508.
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Contact Information

Inquiries concerning this Practice Alert may be directed to –

Phil D. Wedemeyer, Director, Office of Research and Analysis, 202-207-9204, wedemeyerp@pcaobus.org

Thomas Ray, Chief Auditor and Director of Professional Standards, 202-207-9112, rayt@pcabous.org
EXHIBIT "M-4"
U.S. Senate Committee on Banking, Housing, and Urban Affairs

Hearing on:

Stock Options Backdating

Prepared Statement of Mr. Lynn E. Turner

10:00 a.m., Wednesday, September 6, 2002 - Dirksen 538
Chairman Shelby, Ranking Member Sarbanes, thank you for the opportunity to testify before the Senate Banking Committee regarding the growing stock-option scandal. As noted in Appendix A, the number of companies presently caught up in this scandal has mushroomed and now totals in excess of 120. It grows and multiplies each week. Professors Lie and Heron have noted that 18.9% of the unscheduled, at-the-money option grants to top executives during the period 1996-2005 were backdated. This includes a 10% rate subsequent to changes in regulations in 2002, requiring more timely reporting of these transactions. At the same time, investor groups such as the Council of Institutional Investors, the CFA Institute, and leading institutional investors from Australia, Canada, England, the Netherlands, New York, Connecticut, Florida, California, Illinois and elsewhere have written the Securities and Exchange Commission (SEC) expressing “great concern” regarding the backdating of options. Also, I would note the Council of Institutional Investors has written letters to approximately 1,500 companies inquiring of their policies with respect to backdating. To date, approximately 200 of those companies have responded, leaving a big question mark with respect to the other 1,300.

But before I begin, I think it is worth noting that, as BusinessWeek recently reported, the option scandal had its beginnings, in part, in Congress in 1994. That is when the Senate passed a resolution opposing the efforts of the Financial Accounting Standards Board (FASB) to create greater transparency for options. As a direct result of this overreaching interference, during the ensuing 11 years, companies in the Standard & Poor's 500-stock index alone excluded $246 billion in options compensation from net income figures, overstating earnings by 7%.1

Fortunately, when efforts to increase transparency of options arose once again in the aftermath of Enron, investors had a new champion. Chairman Shelby, your courage, your leadership, and your vision of the necessity of honest accounting and full and fair disclosure for the capital markets almost single-handedly prevented Congress from repeating its mistakes of the past. Your support of the FASB’s efforts to reflect the economic reality of options in financial statements ensured greatly enhanced transparency for the 90 million Americans investing in the capital markets. That effort, despite an onslaught of opposition, including by companies now caught up in the option scandal, has helped to mitigate the scandal’s future potential impact.

Let me also say that, as a business executive, I have been both a giver and a receiver of stock options. In the past I have not opposed their use in a thoughtful manner. However, the focus of their use must be on what Franklin Roosevelt called the “...thrill of achievement, in the thrill of creative effort.”2 Not the self-serving, single-minded pursuit of evanescent profits. Not abuses of investor interests through the repricings, early accelerations, or early vesting of options that have become all too common.

1 Business Week, August 31, 2006 in citing statistics from The Analyst's Accounting Observer.
2 Franklin Delano Roosevelt, First Inaugural Address, Washington D.C., March 4, 1933.
I firmly believe that what one manages is what one measures. As a result, requiring the measurement and expensing of the value of options granted as compensation will increase the focus and attention they duly deserve and will help eliminate abuses.

Capital Markets Depend on Integrity and Transparency

As many learned during the early years of this decade — when the markets lost trillions in value, with stockholders actually withdrawing cash — the ability of the U.S. capital markets to attract capital depends on investors having confidence in the integrity and transparency of the markets. Confidence is earned over time through honest and fair markets that provide investors with the material information they need to make informed decisions.

But that confidence can quickly erode if investors believe the markets have become “rigged,” and one party is given an unfair advantage over others. Unfortunately, that is what occurs when an executive who has a fiduciary relationship of trust with shareholders engages in either “backdating” or “spring-loading” of options. The executive uses confidential information, available as a result of his or her position in the company, for self-serving gains. Such is the beginning of what is referred to as a manipulative or deceptive device.

Sam Rayburn, a legend in this town, once said “men charged with the administration of other people’s money must not use inside information for their own advantage.” Indeed, the Securities and Exchange Act of 1934, passed with the help of Rayburn’s leadership, includes a provision that makes it unlawful for people to use “…any manipulative or deceptive device…” in connection with the purchase or sale of a security. Likewise, in the ’34 Act and related rules, Congress and the SEC have made it unlawful for the votes of investors to be solicited in a proxy that contains false or misleading statements with respect to material facts. In particular, Rule 14a-9 specifically addresses false and misleading statements in a proxy provided to investors, including omission of material facts.

With that as background, I would first like to focus my remarks on “spring-loading” of options.

Spring-loading

Let’s say a government contractor receives notice from the government that it has been awarded a profitable contract. The company’s stock is trading at $15 before news of the new contract is disclosed to investors. Three days later, upon the announcement and disclosure of the contract, the company’s stock price increases

to $20. But before the disclosure is made, while the stock is still trading at $15, a grant of options to the top executives is made with an exercise price of $15. In essence, the options have been "spring-loaded" to the tune of $5.

There are a few key points I want to highlight with respect to this spring-loading example. First, the options were not granted at the fair value of the underlying stock. It is clear if the market had the information on the date of the grant with respect to the new contract, the stock would have traded higher. Second, if properly valued using all the available information at the time of the option grant, the grant would have resulted in a benefit to the recipient, as it was granted in-the-money, not at the market price. And finally, generally accepted accounting principles (GAAP) would require the value of such in-the-money options to be expensed under the old accounting rule, Accounting Principles Board Opinion No. 25, or the new accounting rule, FASB statement No. 123R.

Now, some would lead you to believe that granting such "in-the-money" options, or spring-loading, is not a bad thing, not illegal. I beg to differ.

First of all, research has shown that companies include in their annual reports, disclosures such as:

"The Company accounts for those plans using the intrinsic value method prescribed by APB Opinion No. 25, Accounting for Stock Issued to Employees. No stock-based compensation cost is reflected in the statements of operations, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant."

Or:

"As permitted by Statement 123, the Company currently accounts for share-based payments to employees using Opinion 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options."

In addition, I have seen proxy disclosures that indicate options are being granted at the fair value of the underlying stock, and that no gain is available to the executive without further stock appreciation. In cases involving potential spring-loading, they fail to properly disclose the options were granted in the money. In one instance, the disclosure noted the grant of options was designed to align the executive's interests with those of the stockholders, without noting the spring-loading. Likewise, the proxy disclosures fail to note that, when options have been spring-loaded and granted "in-the-money" to the executives, there may be significant negative tax consequences.

If a company has engaged in spring-loading, disclosures such as those above would be misleading to investors and other users of financial statements. First, since the option had an embedded value on the date of grant, the company was
wrong in saying they were granted at the market value. Second, given spring-loaded options are “in the money” at the date of grant, the company should have reported compensation expense under the intrinsic value method required by APB 25. Likewise, any proxy disclosures noting options were granted at fair value, when they in fact were not, would be misleading. So would statements that the options were granted pursuant to plans requiring the options be granted at fair value. The failure to disclose the significant tax implications of not granting the options at the money also would be misleading.

Unfortunately, I have not seen disclosures of the nature the SEC has recently adopted with respect to a company that has a “...plan or practice to select option grant dates...in coordination with the release of material non-public information that is likely to result in an increase in its stock price, such as immediately prior to a significant positive earnings...announcement.” I could not agree more with the SEC when it said “…the Commission believes that in many circumstances the existence of a ...plan...to time the grant of stock options to executives in coordination with material non-public information would be material to investors...”\(^4\) The failure of companies with spring-loading plans to disclose that information is an omission of a material item of interest to investors.

Accordingly, I believe that disclosures made in the past regarding spring-loaded option grants will be found in all too many instances to have been false and misleading, violating the securities laws and regulations.

**Integrity of Management**

Equally important, I believe information regarding the integrity of management is always vitally important and material to investors. After all, what investors want to give management their money when the integrity of that management team is in question?

Yet executives who are found to have spring-loaded or backdated their options will find their integrity challenged as a result of representations they have made to their companies’ auditors, as well as certifications they have made to their companies’ shareholders. When the CEO and CFO complete the financial statements for a company, they must provide the auditors with a representation letter that indicates they have prepared the financial statements in accordance with generally accepted accounting principles. This would include the proper accounting for stock options, including recognizing expense for spring-loaded or backdated options that were granted “in the money.” At the same time, the CEO and CFO must certify to investors that the company has properly prepared its financial statements and has effective internal controls, including over the accounting for options. However, if these executives have engaged in spring-loading (or backdating) options, failed to properly account for these options, and

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failed to note this in their representations to auditors and certifications to investors, consistent with the types of misleading disclosures I discussed earlier, the executives would have once again violated securities laws and regulations.

Accordingly, given that spring-loading certainly can and probably has resulted in improper financial reporting and misleading disclosures, raising serious questions about the integrity of management, I would challenge those who have argued its acceptability to take a closer look at the filings of companies who have engaged in this behavior. I think they will find them most troublesome from the perspective of an investor, as well as a securities regulator.

Late Filings

Now I would like to turn my attention to another issue of concern. That is the issue of late filings. In particular, late filings of the forms the SEC requires to be filed within two days by certain executives or corporate board members, namely Form 4's.

A sample of actual Form 4s for the company, Children's Place Retail Stores, is included as Appendix B. These forms are required to be filed on a timely basis so investors have insights into transactions key insiders are entering into with respect to the stock of the company. In fact, Enron and other corporate scandals highlighted just how late this information was being filed at times, much to the detriment of investors. And, in response to this concern, Congress adopted Section 403 of the Sarbanes-Oxley Act of 2002 to ensure investors received the information within two business days.

However, we continue to see late filings, or, quite frankly, Form 4's that are not filed at all. For example, if you look closely at one of the Children's Place Form 4 filings, you will see it was filed on May 20, 2005. At the same time, the company states that the transaction date was on April 29, 2005, well outside the two-day requirement of SOX. Of interest in this instance is that Children's Place's stock price increased $9.58, or 26%, to $46.79 between the filing date of the Form 4 and the disclosed transaction date. On May 5, 2005, the company issued a press release raising fiscal-year earnings guidance to $2.15-$2.25 a share from $2.10-$2.20 a share. Children's Place does not have an established pattern of granting executive options at this time each year. And while one might well be hesitant to draw conclusions as to why the Form 4 was filed late, the April 29th date did provide an unusually low exercise price for the options.

If the Form 4's had been filed on time, investors would not have to wonder about the integrity of the grant date. That is why it is important the SEC begin to enforce the provisions of SOX that require timely filing. And while I have used Children's Place merely as an example, it is not alone. Companies such as Novatel Wireless, P.F. Chang's, Activision, Sigma Designs and SafeNet are all on a growing list. In fact, if you look at SafeNet's proxy disclosures, which I have
included as Appendix C, you will see the filings themselves show the company repeatedly abused the rules. And despite this constant pattern of late filings, I am not aware of any formal SEC sanctions being handed in a timely fashion to ensure the company and its insiders commence complying with the law. To its credit, SafeNet has disclosed this shortcoming to investors, something that cannot be said for other late filers.

Restatements and Internal Control Weaknesses

Another topic worth noting is the 48 companies that have recently reported they will be delaying providing their investors and the SEC with their financial statements until they are able to complete their own investigations of the matter. Of these companies, 19 have announced they will be restating their financial statements, and certainly a good portion of the remaining 29 could join that group. Another 22 companies that were not late filers this quarter have also announced restatements.

In addition, 18 of the companies listed in Appendix A also reported they had material weaknesses related to their accounting for stock options. As you are well aware, Congress since 1977 has required companies to maintain adequate internal controls that will provide reasonable assurance their financial statements have been properly prepared. Yet we are finding, no doubt due to Section 404 of SOX, that companies have not maintained those necessary controls. Nor in prior years have the executives reported these weaknesses to investors as required by Section 302 of SOX. Both Sections 404 and 302 of SOX -- tools that were not available when this scandal initially began in the Enron era -- should help aid the law-enforcement agencies in cracking down on violators.

Where Were The Gatekeepers?

In what has become a recurring theme in recent years, investors are asking once again: Where were the gatekeepers, including legal counsel and independent auditors?

As both a business executive and corporate board member, my experience has been that legal counsel -- general counsel, if the position exists -- often takes the lead along with the CEO, CFO and vice president in charge of human resources in making the determinations as to option grants, including grant dates. Based on that experience, I would expect legal counsel to have been aware of backdating of options if it occurred. Obviously, one would hope that any legal counsel involved would have had sufficient common sense to have objected to backdating or spring-loading. However, that appears not to have been the case for at least some of the companies.

With respect to independent auditors, I suspect they failed to be skeptical enough with respect to options, despite their known effect on how at least some
executives behave. All too often, it appears they did not pay sufficient attention to the disclosures the company made with respect to option plans and grants. All too often, I have seen auditors pay way too little attention to disclosures in footnotes, merely treating them almost as an afterthought towards the end of an audit. In at least one circumstance now involved in litigation, it has been argued the auditors even gave their blessing to backdating.

However, as a former auditor, I certainly believe that, in some instances, executives at a company could have intentionally withheld critical information on option grants and company performance from the auditors that the auditors otherwise would not have learned of. Accordingly, the auditors would not have detected the misstated financial statements.

Steps to RemEDIATE and Prevent a Recurrence of The Option Scandal

One will naturally ask why a professor, living among the cornfields of Iowa, and two Wall Street Journal reporters were able to bring this scandal to light well before the current rise in the number of law-enforcement investigations. In addition, the question of who thought up the concept of backdating remains unanswered. Hopefully it will be answered through the investigations underway. I will leave those questions for the committee to pursue.

Yet I do think it is important to focus not just on what has transpired, but also on what steps should be taken to ensure it is not repeated.

Benefits of SOX

Certainly, the passage of SOX has helped and will help mitigate the potential for abuse. Its requirements mandate more timely reporting of transactions to investors. They mandate that executives establish their accountability for the company’s financial statements and internal controls. They mandate independent examinations of those controls. And they make it unlawful to mislead independent auditors. I also believe the newly adopted disclosure requirements of the SEC will facilitate greater transparency, as well. I suspect the media attention this matter has received has also sharpened the focus of corporate boards on the issue of grant dates, backdating and spring-loading as well.

But, as we have seen in the past, the allure and upside to options are great, and they at times seemingly have a drug-like effect on rational people’s thinking. As a result, I don’t believe that only the changes made to date will prevent a recurrence of the problem.

Need for Stricter Enforcement and Adequate Resources

I think the changes made to date must be followed up with stricter enforcement of the new rules, which it appears to me has not yet occurred. The SEC needs to
send a clear message through its enforcement actions that investors must be provided information on these transactions through timely filed Form 4’s, coupled with honest and transparent disclosures in financial statements, annual reports and proxies. Companies that have solicited the votes of investors based on misleading disclosures need to be held accountable. While the SEC has announced some 80 ongoing investigations, I am worried that when we look back on this episode in five years or so, we will find these investigations will not have resulted in holding the responsible individuals accountable. This includes gatekeepers who are found to have been actively involved with problematic option grants. Certainly the SEC’s actions will have fallen short if executives, board members or gatekeepers are found to have backdated and/or spring-loaded options in violation of laws, and are not required to disgorge themselves of these ill-gotten gains.

One reason for that concern is the decreasing level of resources being dedicated to the enforcement activities of the SEC staff, including the reviews of filings. For example, in its fiscal 2007 congressional budget request, the SEC includes a request for 1,187 full-time equivalents for the enforcement division and 463 FTE’s for the division of corporation finance, which reviews the filings. Both of these numbers represent declines from the 1,216 budgeted and 1,232 actual FTE’s for the enforcement division in 2006 and 2005, respectively. They also reflect a comparable decline from 478 budgeted and 495 actual FTE’s, respectively, for corporation finance. And while spending is projected to be up slightly in 2007, it appears that increases in salaries are coming at the expense of available staff. I would hope Congress would rethink the wisdom of such cuts to an agency so critical to the capital markets and investors.

At the same time, the SEC’s budget request stated the staff were piloting a number of technology tools to assist them with enforcement and monitoring of filings. Congress should ensure these pilot programs turn into reality. For example, the SEC staff should have the technology available to them that would automatically match up transaction and filing dates from all Form 4’s and generate exception lists whenever a filing is outside the two-day requirement. This should not have to be a manual procedure. At the same time, technology is available whereby option-grant dates can be compared to stock values. Certainly the SEC staff should have these tools available to them to permit quicker identification of these issues.

I would encourage the SEC to step up its enforcement of Section 403 of SOX. As part of each triennial review of a company’s filings mandated by SOX, I believe the SEC staff should review the company’s compliance with the law. And where there are repeat offenses, such as occurred with Safe Net, the SEC should hand out appropriate sanctions AND fines to those late with their filings.

I certainly do support the new SEC disclosure requirements, which are a positive step forward. However, once again, how good they turn out to be will depend on whether they are enforced.
One of the new requirements includes disclosure of the value of option grants calculated in accordance with the new FASB accounting standard. That means these disclosures and the values reported as compensation expense will be only as good as the implementation of that rule. In its comment letter to the SEC, the Council of Institutional Investors stated:

"...the Council believes that the backdating controversy illustrates that the financial accounting and reporting for employee stock option grants is an area in which there is a high risk of intentional misapplication of the accounting requirements. The Council notes that those companies involved in the backdating controversy appear to have failed to complied with the rules-based exception contained in the Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ("Opinion 25")...

...The council, however, is concerned that some preliminary evidence surrounding the adoption of Statement 123R appears to indicate that some companies may be intentionally understating certain inputs required by the standard in an effort to continue the Opinion 25 practice of understating compensation costs and inflating reported earnings. [Footnote omitted] The Council believes that the benefits of Statement 123R will not be fully realized by investors unless and until the SEC closely monitors and rigorously enforces a high quality implementation of the standard’s requirements."

I share the council’s concern and believe it is a valid one. Again, this is an issue of enforcement. If the SEC chooses to go “soft” on the enforcement of the new accounting standard, then it should not be surprised when investors begin to question its commitment to investor protection and the integrity of financial statements.

Changes for Corporate Boards to Consider

Corporate boards, I believe, must also change from being passively involved to one of active involvement with option grants. Corporate boards should be setting the grant dates. I believe it would certainly be a best practice if they chose a set time frame, such as at the annual stockholders meeting, to award option grants. At a minimum, grants should not be permitted during the typical “blackout periods,” when the possibility exists there is material information available that has not yet been disclosed to investors.

In the United Kingdom, I understand that a company is required to notify the stock exchange on the date an option grant is made. Certainly that is a very good practice that should be considered here.

5 New grants for new employee hires may need to be tied to the timing of their hiring.
Finally the treasurer of the state of Connecticut has stated that compensation consultants may be conflicted as a result of services they provide to the executive team. The treasurer has recommended that the SEC require disclosure of such services as an initial step, a recommendation I concur with.

**Bringing Closure to The Scandal**

Finally, let me close by noting that investors have now suffered through a growing list of companies disclosing they have been caught up in the backdating scandal. In the mid 1970’s, the SEC faced a similar scandal involving illegal payment of corporate bribes. After initially involving a dozen or so companies, more than 400 companies were found to have engaged in improper payments and behavior, along with lax accounting in their books and records. Given the magnitude of the issue confronting the agency, and realizing its enforcement resources were going to be insufficient to deal with the breadth of the scandal, then-SEC Chairman Roderick M. Hills announced a program urging companies to self-investigate and, when problems were found, provide independent reports to the SEC along with full disclosure to investors. In turn, the SEC stated that, with adequate disclosure, it would not pursue enforcement remedies unless fraudulent behavior was found, in which case the SEC reserved its legal rights.

Today, I believe the SEC faces a similarly daunting task. With a reported 80 investigations already underway, I see no way the SEC staff, with current resources, can or will adequately investigate all of these cases. As we also continue to find dubious cases of option granting in our own research, I believe we will find many more -- perhaps hundreds of companies -- that have yet to report inappropriate disclosure and accounting of stock-option grants. Certainly, Prof. Lie’s research makes that a possibility.

Accordingly, I would hope this committee would urge the SEC to undertake a program, as it has in the past, to more quickly bring this issue to the forefront and to conclusion, while allowing companies to get on with their business. Investors should no longer have to suffer this Chinese water torture, as news of another company backdating continues to drip out.

**In Closing**

Let me close by noting that I have devoted little time to backdating of options. This is a practice akin to winning the lottery or betting on a race, after the race is over. For that reason, there has been universal agreement that backdating of options is unlawful and should be punished with the full force of the laws, especially when it is done through backdating of documents or involves the misleading of auditors or corporate boards. As such, I have left that topic to be addressed by others today.
However, I do believe spring-loading of options cannot be justified anymore than backdating. It once again provides the insider with an advantage other corporate shareholders do not receive, and I have yet to see it done with full and fair disclosure and appropriate treatment in the financial statements. Once that is forced to occur, and sunlight is focused on this affliction, I suspect this practice will cease to exist. Indeed, it is this lack of transparency that has permitted some unscrupulous executives to engage in doing what they will not do when fully exposed.
At least 128 companies have announced internal reviews, SEC inquiries, or Justice Department subpoenas related to their historical stock-option grants. We provide details for these companies in the following table. (List as of Sept. 1, 2006.)

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<th>Company</th>
<th>Market Value</th>
<th>Market Cap 1</th>
<th>Internal Review</th>
<th>SEC Inquiry</th>
<th>Shareholder Suits</th>
<th>Criminal Charges</th>
<th>Executive Departures</th>
<th>Restatements</th>
<th>Late Filings</th>
<th>Material Weaknesses</th>
<th>EPS Rationales</th>
<th>FASB Comment Letters</th>
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Legend: Market value - company's market capitalization as of Aug. 15, 2006. Internal - company announced an internal review. SEC - company is part of a Securities and Exchange Commission informal inquiry or investigation. DoJ - company received a subpoena from U.S. attorney. Shareholder suits - company was named a defendant in shareholder litigation. Criminal cases - criminal charges were filed against company executives. Executive or director departures - company officers or directors resigned or were fired in connection with the company's stock option investigation. Restatements - company announced it will restate historical financial statements to correct stock-based compensation expense and filed an 8-K, Item 4.02, for non-reliance on previously issued financial statements. Late filings - company delayed at least one annual or quarterly filing in connection with its stock option review. Material weaknesses - company disclosed it has a material weakness in its internal controls related to accounting for stock options. Accel. vesting - company accelerated the vesting of its stock options before FAS 123R went into effect. FASB comment letters - company sent a comment letter to the Financial Accounting Standards Board that opposed either the original FAS 123 exposure draft (1994), or the Share-Based Payment (a.k.a. FAS 123R) exposure draft (2004), both of which proposed the expensing of employee stock options. IESOC - company was a member of the International Employee Stock Option Coalition, a group of companies and organizations that opposed FAS 123 and the expensing of stock options.
**Statement of Changes in Beneficial Ownership**

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

<table>
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<tr>
<th>1. Name and Address of Reporting Person</th>
<th>2. Issuer Name and Ticker or Trading Symbol</th>
<th>5. Relationship of Reporting Person(s) to Issuer</th>
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<td>CIAMPI MARIO</td>
<td>CHILDRENS PLACE RETAIL STORES INC [PLCE]</td>
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<tr>
<td>(Last) (First) (Middle)</td>
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<td>Director 10% Owner</td>
</tr>
<tr>
<td>915 SECAUCUS ROAD</td>
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<td>Officer (give title below)</td>
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<td>X Sr. VP</td>
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<td>(Street)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SECAUCUS NJ 07094</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(City) (State) (Zip)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3. Date of Earliest Transaction (Month/Day/Year): 04/29/2005

4. If Amendment, Date of Original Filed (Month/Day/Year): X

6. Individual or Joint/Group Filing (Check Applicable Line):

- X Form filed by One Reporting Person
- Form filed by More than One Reporting Person

**Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned**

<table>
<thead>
<tr>
<th>1. Title of Security (Instr. 3)</th>
<th>2. Transaction Date (Month/Day/Year)</th>
<th>2A. Deemed Execution Date, If any (Month/Day/Year)</th>
<th>3. Transaction Code (Instr. 3, 4 and 5)</th>
<th>4. Securities Acquired (A) or Disposed Of (D) (Instr. 3, 4 and 5)</th>
<th>5. Amount of Securities Beneficially Owned (A) or (D) (Instr. 3, 4 and 5)</th>
<th>6. Ownership Form: Direct (D) or Indirect (I)</th>
<th>7. Nature of Indirect Beneficial Ownership</th>
</tr>
</thead>
</table>

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Form 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

O.M.B. APPROVAL
OMB Number: 3235-0287
Expires: January 31, 2008
Estimated average burden hours per response: 0.5
### Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned (e.g., puts, calls, warrants, options, convertible securities)

<table>
<thead>
<tr>
<th>1. Title of Derivative Security (Instr. 3)</th>
<th>2. Conversion or Exercise Price of Derivative Security</th>
<th>3. Transaction Date (Month/Day/Year)</th>
<th>3A. Deemed Execution Date, if any (Month/Day/Year)</th>
<th>4. Transaction Code (Instr. 6)</th>
<th>5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)</th>
<th>6. Date Exercisable and Expiration Date (Month/Day/Year)</th>
<th>7. Title and Amount of Securities Underlying Derivative Security (Instr. 3 and 4)</th>
<th>8. Price of Derivative Security (Instr. 6)</th>
<th>9. Number of derivative Securities Beneficially Owned Following Reported Transaction(s) (Instr. 4)</th>
<th>10. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)</th>
<th>11. Nature of Indirect Beneficial Ownership (Instr. 4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Stock Option (right to buy)</td>
<td></td>
<td>04/29/2005</td>
<td></td>
<td>$37.66</td>
<td>80,000</td>
<td>04/28/2006 04/29/2015</td>
<td>Common Stock 80,000 $37.66 219,000 (2)</td>
<td>D</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Explanation of Responses:**

1. **Exercisable cumulatively at the rate of 25% on April 28, 2006 and 25% each year thereafter.**
2. **Includes (i) 86,600 employee stock options currently exercisable and (ii) 132,400 employee stock options exercisable over the next 4 years.**

**Remarks:**

*Mario Ciampi 05/20/2005*

**Signature of Reporting Person**

*Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.*

*If the form is filed by more than one reporting person, see Instruction 4 (b)(v).*


*Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, see Instruction 6 for procedure.*
Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB Number.
1. Name and Address of Reporting Person
DABAH EZRA
(Last) (First) (Middle)
915 SECAUCUS ROAD

2. Issuer Name and Ticker or Trading Symbol
CHILDRENS PLACE RETAIL STORES INC [ PLCE ]

3. Date of Earliest Transaction (Month/Day/Year)
04/29/2005

4. If Amendment, Date of Original Filed (Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer
(Click all applicable)
Director X 10% Owner
Officer (give title below)
Other (specify below)

6. Individual or Joint/Group Filing (Check Applicable Line)
X Form filed by One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

| 1. Title of Security (Instr. 3) | 2. Transaction Date (Month/Day/Year) | 2A. Deemed Execution Date, if any (Month/Day/Year) | 3. Transaction Code (Instr. 3, 4 and 5) | 4. Securities Acquired (A) or Disposed Of (D) (Instr. 3, 4 and 5) | 5. Amount of Securities Beneficially Owned | 6. Ownership Form: Direct (D) or Indirect (I) | 7. Nature of Indirect Beneficial Ownership |
|---------------------------------|-------------------------------------|-----------------------------------------------|---------------------------------|-------------------------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
**Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned**

<table>
<thead>
<tr>
<th>Employee Stock Options (right to buy)</th>
<th>Code</th>
<th>Amount</th>
<th>(A) or (D)</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
<td>85,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date Exercisable</th>
<th>Expiration Date</th>
<th>Title and Amount of Securities Underlying Derivative Security</th>
<th>Price of Derivative Security</th>
</tr>
</thead>
<tbody>
<tr>
<td>04/28/2006</td>
<td>04/29/2010</td>
<td>Common Stock 85,000 (1)</td>
<td>$41.42</td>
</tr>
<tr>
<td>04/29/2010</td>
<td>284,660 (2)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Explanation of Responses:**

1. Exercisable cumulatively at the rate of 25% on April 28, 2006 and 25% each year thereafter.
2. Consists of 99,660 employee stock options currently exercisable and 185,000 employee stock options exercisable over the next four years.

**Remarks:**

Renee Dabah 05/20/2005

**Signature of Reporting Person Date**

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

*If the form is filed by more than one reporting person, see Instruction 4 (b)(v).


Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, see Instruction 6 for procedure.
Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB Number.
STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

1. Name and Address of Reporting Person
DABAH EZRA
915 SECAUCUS ROAD
SECAUCUS NJ 07094

2. Issuer Name and Ticker or Trading Symbol
CHILDRENS PLACE RETAIL STORES INC [PLCE]

3. Date of Earliest Transaction (Month/Day/Year)
04/29/2005

4. If Amendment, Date of Original Filed (Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer (Check all applicable)
X Director X 10% Owner

6. Individual or Joint/Group Filing (Check Applicable Line)
X Form filed by One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)

2. Transaction Date (Month/Day/Year)

2A. Deemed Execution Date, if any (Month/Day/Year)

3. Transaction Code (Instr. 3, 4 and 5)

4. Securities Acquired (A) or Disposed Of (D) (Instr. 3, 4 and 5)

5. Amount of Securities Beneficially Owned

6. Ownership Form: Direct (D) or Indirect (I)

7. Nature of Indirect Beneficial Ownership
Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned  
(e.g., puts, calls, warrants, options, convertible securities)

<table>
<thead>
<tr>
<th>Employee Stock Options (right to buy)</th>
<th>Code</th>
<th>V</th>
<th>Amount</th>
<th>Date Exercisable</th>
<th>Expiration Date</th>
<th>Title</th>
<th>Amount or Number of Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>V</td>
<td></td>
<td>$41.42</td>
<td>04/28/2006 (1)</td>
<td>04/29/2010</td>
<td>Common Stock</td>
<td>85,000</td>
</tr>
</tbody>
</table>

**Explanation of Responses:**

1. Exercisable cumulatively at the rate of 25% on April 28, 2006 and 25% each year thereafter.
2. Consists of 99,660 employee stock options currently exercisable and 185,000 employee stock options exercisable over the next 4 years.

**Remarks:**

Ezra Dabah  
**Signature of Reporting Person**  
05/20/2005  
**Date**

**Reminder:** Report on a separate line for each class of securities beneficially owned directly or indirectly.

* If the form is filed by more than one reporting person, see Instruction 4 (b)(v).


Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, see Instruction 6 for procedure.
Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB Number.
Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned (e.g., puts, calls, warrants, options, convertible securities)

<table>
<thead>
<tr>
<th>1. Title of Derivative Security (Instr. 3)</th>
<th>2. Conversion or Exercise Price of Derivative Security</th>
<th>3. Transaction Date (Month/Day/Year)</th>
<th>3A. Deemed Execution Date, if any (Month/Day/Year)</th>
<th>4. Transaction Code (Instr. 8)</th>
<th>5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)</th>
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<th>7. Title and Amount of Securities Underlying Derivative Security (Instr. 3 and 4)</th>
<th>8. Price of Derivative Security (Instr. 5)</th>
<th>9. Number of derivative Securities Beneficially Owned Following Reported Transaction(s) (Instr. 4)</th>
<th>10. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)</th>
<th>11. Nature of Indirect Beneficial Ownership (Instr. 4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Stock Options (right to buy)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Code V (A) (D)</td>
<td>Date Exercisable (1) Expiration Date</td>
<td>Title Common Stock 85,000 $37.66 $385,000 (2)</td>
<td>D</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Explanation of Responses:
1. Exercisable cumulatively at the rate of 25% on April 28, 2006 and 25% each year thereafter.
2. Consists of 50,000 employee stock options currently exercisable and 335,000 employee stock options exercisable over the next 4 years.

Remarks:

Neal Goldberg 05/20/2005

** Signature of Reporting Person

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

* If the form is filed by more than one reporting person, see Instruction 4 (b)(v).


Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, see Instruction 6 for procedure.
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# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

<table>
<thead>
<tr>
<th>1. Name and Address of Reporting Person</th>
<th>2. Issuer Name and Ticker or Trading Symbol</th>
<th>3. Date of Earliest Transaction (Month/Day/Year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GOLDBERG NEAL</td>
<td>CHILDRENS PLACE RETAIL STORES INC [PLCE]</td>
<td>04/21/2005</td>
</tr>
<tr>
<td>(Last)</td>
<td>(First)</td>
<td></td>
</tr>
<tr>
<td>915 SECAUCUS ROAD</td>
<td>(Middle)</td>
<td></td>
</tr>
<tr>
<td>(Street)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SECAUCUS NJ</td>
<td>07094</td>
<td></td>
</tr>
<tr>
<td>(City)</td>
<td>(State)</td>
<td>(Zip)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>4. If Amendment, Date of Original Filed (Month/Day/Year)</th>
<th>5. Relationship of Reporting Person(s) to Issuer (Check all applicable)</th>
</tr>
</thead>
<tbody>
<tr>
<td>04/25/2005</td>
<td>Director</td>
</tr>
<tr>
<td></td>
<td>10% Owner</td>
</tr>
<tr>
<td></td>
<td>Other</td>
</tr>
<tr>
<td></td>
<td>(specify below)</td>
</tr>
<tr>
<td></td>
<td>Officer (give title below)</td>
</tr>
<tr>
<td></td>
<td>President</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>6. Individual or Joint/Group Filing (Check Applicable Line)</th>
</tr>
</thead>
<tbody>
<tr>
<td>X Form filed by One Reporting Person</td>
</tr>
<tr>
<td>Form filed by More than One Reporting Person</td>
</tr>
</tbody>
</table>

### Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

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<td>3A. Deemed Execution Date, if any (Month/Day/Year)</td>
<td>4. Transaction Code (Instr. 6)</td>
<td>5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)</td>
<td>6. Date Exercisable and Expiration Date (Month/Day/Year)</td>
<td>7. Title and Amount of Securities Underlying Derivative Security (Instr. 3 and 4)</td>
</tr>
<tr>
<td>----------------------------------------</td>
<td>--------------------------------------</td>
<td>----------------------------------</td>
<td>---------------------------------</td>
<td>-----------------</td>
<td>----------------------------------</td>
<td>----------------------------------</td>
<td>----------------------------------</td>
</tr>
<tr>
<td>Employee Stock Options (right to buy)</td>
<td>$40.65</td>
<td>04/21/2005</td>
<td></td>
<td>A</td>
<td>50,000</td>
<td>04/30/2005 (1)</td>
<td>01/21/2014</td>
</tr>
</tbody>
</table>

Explanation of Responses:
1. Exercisable cumulatively at the rate of 20% on October 31, 2005, 20% on January 31, 2006 and 20% on each subsequent January 31st thereafter.
2. Consists of 50,000 employee stock options currently exercisable and 250,000 employee stock options exercisable over the next 4 years.

Remarks:

Neal Goldberg 05/20/2005
** Signature of Reporting Person Date

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.
* If the form is filed by more than one reporting person, see Instruction 4 (b)(v).
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Appendix C

Proxy Disclosure of Repeated Late Form 4 Filings
Compliance with Section 16(a) of the Exchange Act

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the Company's executive officers and directors, and persons who own more than 10% of the outstanding shares of Common Stock, to file reports of ownership and changes in ownership with the Securities and Exchange Commission. Based solely on a review of the copies of such reports furnished to the Company and written representations from the executive officers and directors, the Company is aware of the following instances of noncompliance or late compliance with such filings during the fiscal years ended December 31, 2005, 2004, 2003 and 2002, respectively, by its executive officers and directors:

- As first reported in the Company's Form 10-K/A filed with the Securities and Exchange Commission on April 11, 2006, with respect to the fiscal year ended December 31, 2005, Messrs. Brooks, Harrison and Lesem and Ms. Argo each failed to file two Forms 4 during the year to report two separate grants of stock options, and Messrs. Clark, Hunt, Money, Straub, Thaw, Caputo, Mueller (a former executive officer of the Company) and Fedde each failed to file one Form 4 during the year to report one grant of stock options;

- With respect to the fiscal year ended December 31, 2004, Mr. Harrison failed to file two Forms 4 during the year to report two separate grants of stock options, and Messrs. Brooks, Clark, Hunt, Money, Straub, Thaw, Caputo, Fedde and Mueller and Ms. Argo each failed to file one Form 4 during the year to report one grant of stock options;

- With respect to the fiscal year ended December 31, 2003, Messrs. Brooks, Clark, Harrison, Hunt, Thaw, Fedde and Ms. Argo each failed to file two Forms 4 during the year to report two separate grants of stock options, and Messrs. Caputo, Money and Straub each failed to file one Form 4 during the year to report one grant of stock options; and

- With respect to the fiscal year ended December 31, 2002, Mr. Caputo failed to file one Form 4 to report one grant of stock options.
Each of the transactions listed above was reported on a Form 5 filed after the end of each of the respective fiscal years rather than a Form 4, as was required beginning August 29, 2002 pursuant to the Sarbanes-Oxley Act of 2002. The Company is aware of compliant Forms 4 reports during this period being filed for transactions involving sales and purchases of the Company's stock, as well as stock option exercises. The Company is continuing to review prior filings under Section 16(a) of the Exchange Act for completeness.

Legal Proceedings

On May 18, 2006, the Company announced that it has received a subpoena from the office of the United States Attorney for the Southern District of New York relating to the Company's granting of stock options. The Company also announced that it has received an informal inquiry from the Securities and Exchange Commission requesting information relating to stock option grants to directors and officers of the Company, as well as information relating to certain accounting policies and practices. The Company is actively engaged in responding to these requests and is cooperating with both offices.

On and after May 31, 2006, individuals claiming to be shareholders of the Company filed multiple derivative complaints in the Circuit Court for Harford County, Maryland, against current and former officers and directors of the Company, as well as the Company as a nominal defendant. The complaints allege state law claims for breach of fiduciary duty and unjust enrichment arising from alleged backdating of stock option grants. On and after June 6,
2006, individuals claiming to be shareholders of the Company filed multiple derivative complaints in the United States District Court for the District of Maryland, purportedly on behalf of the Company, against the current directors and certain current and former officers of the Company, as well as the Company as a nominal defendant. The complaints allege, among other things, claims for breach of fiduciary duties and unjust enrichment and claims under Section 304 of the Sarbanes-Oxley Act of 2002 arising from alleged backdating of stock option grants and alleged dissemination of misleading and inaccurate information through public statements, including filings with the Securities and Exchange Commission. The Board of Directors has directed a special committee of the board to investigate these allegations. This special committee has retained independent counsel and has the authority to retain such other advisers as it deems appropriate to assist in the investigation.

In addition, the Company has also received a letter from a law firm, allegedly on behalf of an unidentified shareholder, demanding that the Board of Directors recover short swing profits alleged to be made by officers and directors in alleged violations of Section 16(b) of the Securities Exchange Act of 1934, as amended. The special committee also will investigate these allegations.
EXHIBIT "M-5"
Testimony of

Erik Lie
Associate Professor of Finance
Henry B. Tippie College of Business
University of Iowa

Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs

September 6, 2006

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee:

Thank you for inviting me to testify today about stock options backdating. In theory, stock options can be used to motivate executives and other employees to create value for shareholders. However, they have also been used to (i) conceal true compensation expenses, (ii) cheat on corporate taxes, and (iii) siphon money away from shareholders to option recipients. I will take this opportunity to offer some background on stock options and stock option grants, describe the practice of backdating, and make some recommendations for the future.

BACKGROUND ON STOCK OPTIONS AND STOCK OPTIONGrants

Let me first provide some background on and mention some key aspects of executive stock options and option grants.

- A stock option gives its owner the right to buy the stock of the company in the future.
- Stock options are granted to executives at various intervals. It is common to grant options once a year, though it is also possible for executives not to be granted options in a year or to be granted options numerous times in a year. In most cases, there is no fixed schedule to these grants, meaning that they do not occur on the same date (e.g., on July 1) in consecutive years.
- Before August 29, 2002, executive option grants had to be filed anywhere from 10 business days to more than a year after the grant, depending on (i) when a grant occurred within a calendar month and fiscal year and (ii) whether a Form 4 or Form 5 was used when filing the grants with the SEC. Under the current regulations that took effect on August 29, 2002 as part of the Sarbanes-Oxley Act, option grants to executives have to be filed with the Securities and Exchange Commission (SEC) within two business days. Distributions of the number of days between the official grant date and the filing date based on a sample of about 40,000 grants to top executives between 1996 and 2005 are given in the graph below. The new filing requirement dramatically reduced the lag between the grant date and the filing date. Importantly, about 22% of grants since August 29, 2002 were filed late, and almost 10% were filed at least one month late.
Most options granted to executives expire after exactly 10 years.

The price at which the stock can be bought is determined at the time of the grant and generally does not change. It is called the “exercise price” or the “strike price.”

Most executive stock options are granted “at-the-money,” i.e., the exercise price is set to equal the stock price on the day of the grant. (“In-the-money” means that the exercise price is below the stock price, and “out-of-the-money” means that the exercise price is above the stock price.)

In a sample of 40,000 grants from 1996 to 2005, the exercise price matches the closing price on the grant day in 50% of the cases and the closing price on the day before the grant day in 12% of the cases.

There are several reasons why options are granted at-the-money:

- Accounting Principles Board (APB) Opinion No. 25, which was phased out in 2005, allowed companies to expense options according to the intrinsic value method, whereby the expense equals the difference between the fair value of the underlying stock and the exercise price of the option. Under this rule, at-the-money options did not have to be charged against reported earnings. (Under FAS 123R, which replaced APB 25, companies have to expense the fair market value of the options at the time of the grant.)

- Unlike in-the-money grants, at-the-money grants qualify as performance-based compensation. As such, at-the-money grants receive favorable tax treatment under Section 162(m) of the Internal Revenue Code, which limits the deductibility of nonperformance-based compensation for tax purposes to one million dollars per executive.

- Incentive stock options (ISOs), which are often a part of broad-based option plans that could qualify for more favorable tax treatment than non-qualified options at the individual level, cannot be granted in-the-money. Note, however, that most options granted to executives are non-qualified options.
(NQOs), and not ISOs, as ISOs are limited to a value of $100,000 per employee per calendar year and also count as income in the determination of the Alternative Minimum Tax (AMT).

- At-the-money grants might be perceived as a better incentive mechanism than in-the-money options, because executives are only rewarded if the stock price increases.

- The practice of granting options at-the-money provides the incentives to time the grant to occur on a day when the stock price was particularly low and/or to manipulate the information flow around the grant date. (Note that these incentives would be present for in-the-money and out-of-the-money grants also, provided that the exercise price is a function of the stock price, e.g., 90% or 110% of the stock price.)

- Some potential strategies that might be used to inflate the value of option grants include the following:
  - Spring-loading/Bullet-dodging: The terms "spring-loading" and "bullet-dodging" refer to the practices of timing option grants to take place before expected good news or after expected bad news, respectively. They have also been referred to as "forward dating."
  - Manipulation of the information flow: This refers to the practice of timing corporate announcements relative to known future option grant dates. For example, if a firm will soon announce a share repurchase plan that is expected to raise the stock price, this announcement might be postponed until after the option grant.
  - Backdating: This refers to the practice of cherry-picking a date from the past when the stock price was relatively low to be the official grant date.

**RESEARCH ON OPTION GRANT TIMING**

In a 1997 study entitled “Good timing: CEO stock option awards and company news announcements,” David Yermack of New York University reported that the average abnormal stock return during the months after option grants to CEOs between 1992 and 1994 exceeds 2%, which he interpreted as evidence that the grants are timed to occur before anticipated stock price increases (i.e., spring-loading).

In a 2000 study entitled “CEO stock option awards and the timing of corporate voluntary disclosures,” David Aboody of UCLA and Ron Kasznik of Stanford University reported that the average abnormal stock return is positive even for a subsample of grants between 1992 and 1996 that appear to be scheduled. They interpreted this as evidence that the information flow around grants is manipulated.

In my 2005 study entitled “On the timing of CEO stock option awards,” I documented negative abnormal stock returns before and positive returns after CEO option grants between 1992 and 2002, and these trends intensified over time. I further reported that the portion of the stock returns that is predicted by overall market factors exhibits a similar pattern, prompting my conclusion that “unless executives have an informational advantage that allows them to develop superior forecasts regarding the future market movements that...”
drive these predicted returns, the results suggest that the official grant date must have been set retroactively” (p. 811).

In a soon-to-be-published study entitled “Does backdating explain the stock price pattern around executive stock option grants?” that I coauthored with Randy Heron of Indiana University, we found further evidence in support of my earlier backdating argument. As noted earlier, a provision in Sarbanes-Oxley reduces the SEC filing requirement for new option grants to two days from the earlier requirements that allowed executives to report grants up to several months after the grant date. To the extent that companies comply with this new requirement, backdating should be greatly curbed. Thus, if backdating explains the stock price pattern around option grants, the price pattern should diminish following the new requirements. Indeed, we found that the stock price pattern is much weaker since the new reporting requirements took effect. Any remaining pattern is concentrated on the couple of days between the reported grant date and the filing date (when backdating still might work), and for longer periods for the minority of grants that violate the two-day reporting requirements. I replicated these results in the figure below using a sample of about 40,000 grants to top executives during the period 1996-2005. We interpreted the findings as strong evidence that backdating explains most of the abnormal price pattern around option grants.

In an unpublished study entitled “What fraction of stock option grants to top executives have been backdated or manipulated?” Randy Heron and I used a sample of 39,888 grants to top executives across 7,774 companies between 1996 and 2005 to estimate the following:
• 14% of all grants to top executives dated between 1996 and 2005 were backdated or otherwise manipulated.

• 23% of unscheduled, at-the-money grants to top executives dated between 1996 and August 2002 were backdated or otherwise manipulated.

• This fraction was more than halved to 10% as a result of the new two-day reporting requirement that took effect in August 2002.
  o Among the minority of unscheduled, at-the-money grants after August 2002 that were filed late (i.e., more than two business days after the purported grant dates), 20% were backdated or otherwise manipulated.
  o Among the majority of unscheduled, at-the-money grants after August 2002 that were filed on time, 7% were backdated or otherwise manipulated. (The benefit of backdating is naturally greatly reduced in such cases.)

• The prevalence of backdating differs across firm characteristics; backdating is more common among
  o tech firms,
  o small and medium firms (i.e., those with a market capitalization less than $1 billion), and
  o firms with high stock price volatility.

• The auditing firm is only modestly associated with the incidence of backdating.
  o PricewaterhouseCoopers is associated with a slightly lower fraction of backdated grants after controlling for other factors.
  o Non-big-five auditing firms are associated with a higher fraction of both late filings and unscheduled grants, which appear to result in more backdating.

• 29% of firms that granted options to top executives between 1996 and 2005 manipulated one or more of these grants in some fashion.

**IS OPTION GRANT TIMING ILLEGAL?**

There is an ongoing debate regarding whether spring-loading and bullet-dodging are illegal. These practices have been compared to insider trading of stock. The debate hinges on the definition of the “harmed party.” In regular insider trading cases, one party in the transaction possesses inside information that the other party (the harmed party) does not possess. In cases of option grants, some have argued that both parties, i.e., the option recipient and the Board of Directors of the firm that grants the options, have access to the same inside information, so it is not the case that the option recipient exploits an informational advantage. The other point of view is that insiders, with the consent of the Board of Directors, are using their informational advantage to extract additional compensation from the firm’s owners (shareholders). Under this viewpoint, the harmed party would be the firm’s existing shareholders, who do not possess the same information, and whose ownership value is reduced to a greater degree than would otherwise be the case.
Backdating is less ambiguous. If options purported to be at-the-money on the backdated grant date were in-the-money on the actual grant date (which should be the measurement date for financial and tax reporting purposes) and not properly accounted for, then

- the firm’s reported earnings were too high according to the accounting regulations (under both APB 25 and FAS 123R),
- the firm’s taxes might have been too low (due to IRC § 162(m), and because the deductible spread between the exercise price and the stock price at the time of the actual option exercises is artificially inflated),
- if the options are ISOs, one of their requirements for their favored tax-status have been violated, and
- any requirement in the option plan that the options should be granted at the fair market value is violated.

In addition, to implement the backdating strategy, documents might have been forged, which is a federal offense.

**CONCLUSION**

Backdating of option grants was a pervasive practice among publicly traded corporations in the U.S. in the late 1990s and the beginning of this century. My own research suggests that spring-loading, bullet-dodging, and manipulation of the information flow was either significantly less prevalent or less successful in the aggregate in producing immediate gains for the option recipients during the same period.

The problem of backdating can be eliminated by requiring grants to be filed electronically with the SEC on the same day that they are granted. Given that (i) the form for filing this information is very simple and (ii) the forms can be filed online, this is a reasonable requirement, and, in fact, some grants are already filed on the grant date. Of course, this requirement has to be strictly enforced with appropriate penalties for any violation, such that the frequency of late filing that is evident for the last few years is greatly reduced.

As the problem of backdating is eliminated, the problems of spring-loading, bullet-dodging and manipulation of the information flow might become more prominent. Thus, it is critical to clarify whether these alternative strategies are legal. If so, restrictions to minimize their occurrence should be developed. In particular, options should not be granted near major corporate announcements. Further, there should be timely and complete disclosure of grants.

Finally, to eliminate timing relative to recent stock prices, the benchmark stock price should be the price on the grant date. For example, if the options are granted at-the-money, the exercise price should be set to equal the stock price on the grant day rather than the stock price on the prior day, which is a fairly common practice (see earlier statistics). This eliminates the possibility that options are granted on a day when the price has increased significantly but the prior day’s lower price is used for contracting purposes.
EXHIBIT "M-6"
STATEMENT OF KURT N. SCHACHT, CFA
EXECUTIVE DIRECTOR
CFA CENTRE FOR FINANCIAL MARKET INTEGRITY
UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING and URBAN AFFAIRS
Options Backdating Hearing
September 6, 2006

INTRODUCTION

I am Kurt Schacht, the Executive Director of the CFA Centre for Financial Market Integrity, the advocacy arm of CFA Institute. I would like to thank Senator Shelby, Senator Sarbanes and other members of this committee for the opportunity to speak to you today on the topic of stock option practices, in particular backdating of option grants. This issue raises important shareholder concerns and we are supportive of your committee taking a closer look, as well as the work of Chairman Cox and the Securities and Exchange Commission (SEC) to investigate alleged abuses.

First, some background about CFA Centre and its parent organization, CFA Institute. CFA Institute is a non-profit professional membership organization with over 84,000 members in 128 countries. Its mission is to lead the investment profession globally by setting the highest standards of ethics, education, and professional excellence. CFA Institute is most widely recognized as the organization that administers the CFA examination and awards the CFA designation, a designation that I share with nearly 68,000 investment professionals worldwide. I direct the advocacy efforts of CFA
InstitutethroughthenewlycreatedCFACentreforFinancialMarketIntegrity,which
developsresearch,educationprojectsandpromotesethicalstandardswithinthe
investmentindustry.

THE CFA CENTRE PERSPECTIVE: OPTIONS BACKDATING

Ourorganizationapproachesthistopicprimarilyasaninvestoradvocatewithafocuson
protectingshareholderinterestsandensuringaccurateandtransparentfinancialreporting.
WewereanearyvoicefortheSECtoamenditsnewlyreleasedexecutivecompensation
disclosures to deal with the practice of option backdating and its companion practice of
“spring-loading.” Both have been prevalent for years and have generally gone unnoticed.
In some cases, these practices have been purposefully hidden from shareholder view. The
recent focus by various academic studies and the resulting regulatory investigations into
thebackdatingpracticeshaveconfirmedwhatisatbest,thelatestexecutive
compensationcontroversyandatworst,agrowingfinancialreportingscandal.

Historically, the rationale for granting stock options to executives and other employees
was to aligntheirinterestswithshareowners, and to provide an incentive for them to
enhance shareholder value. Several commentators have suggested that even backdated
options continue to have such attributes and that the backdating controversy is overblown
withpoliticsandrhetoric. They would have us believe it is a “victimless” infraction. In
ourview, thepracticesofbackdatingandspring-loadingareunethicalmaneuversthes
optiongrantingprocessdesignedtoincreaseemployees’compensationtothedetermi
ofshareowners. Thesepracticeshavebeensecretiveandhaveplacednumerous
companies at significant financial and leadership risk. As with most company scandals resulting in significant cost and uncertainty, it is the public shareowners that fall victim.

We remain concerned about the ultimate scope of the backdating problem. Specifically, is this activity limited to the 100-plus firms under formal investigation or does it extend to a much larger group? For a variety of reasons, including the recent public outrage, the requirements of FASB Statement 123R and APB Opinion 25, the Sarbanes Oxley requirement to file accelerated Form 4’s and the new SEC compensation disclosure rules, backdating itself may be yesterday’s problem. However, the degree of necessary “clean-up” due to the vast number of companies and the size of stock options incentives in 1990-2002, seems to be unknown. It represents an overhang for individual companies for sure, but more problematic, it must not become a sequel to the lost confidence in financial reporting experienced earlier in this decade.

One mitigating factor may be that in recent months, the use of stock options has fallen out of favor due partly to the new option expensing rules. Whether we consider long term effects or short term effects of backdating and spring-loading, options use has become more rationalized. What this may signal however, is a need for further examination of the “replacement” for options, the practice of granting restricted stock. We should be certain that the gaming of grant dates or material information has not become part of the calculus for this now more favored type of stock incentive.
One final point of perspective relates to the ethical implications of backdating. This controversy comes at a time when executive compensation practices in general, are under intense scrutiny. These latest revelations concerning backdating and spring-loading certainly appear to be yet more practices intentionally conducted under the radar, for obvious reasons. It leaves many wondering about the respective standards and duties of officers and directors who approved of and even participated in some of these option granting irregularities. This is all the more troubling given that the practice appears to have continued after Sarbanes Oxley was passed in 2002 and suggests that at least some compensation and audit committee members may have been less than diligent in their duties.

ACCOUNTING AND AUDITING PRACTICE - WHAT HAPPENED?

The accounting standard relating to stock option expenses that existed for many years before FASB Statement 123R was clear. APB Opinion 25 allowed companies to avoid a compensation expense only if certain criteria were met. Such criteria clearly included a requirement that the underlying stock price on the date of the grant must be equal to the exercise price of the options. Stated differently, the grant date price and the exercise price must match, in order to avoid the attendant compensation expense.

It is difficult to fashion an argument as to how this might ever happen in the context of backdating an option grant. Therefore, in nearly every case where an option grant date was backdated, a compensation expense was required to be recognized and reported in the company’s income statement, unless it was deemed immaterial. As a result, nearly
every company identified in the press as having backdating problems failed to properly record compensation expense for options and thereby filed financial statements that did not comply with the U.S. Generally Accepted Accounting Principles (GAAP) (again, unless the amount of expense was "immaterial").

Viewing this in the context of external auditor responsibilities, it remains unclear how this practice was repeatedly missed or worse, sanctioned. In some cases it may have been sloppiness, incompetence or both. In other cases it may have been an intentional act of concealment by the responsible managers. A number of the accounting firms have suggested that the client company's option documentation was typically taken at face value. Such documentation would generally indicate that the company had granted at-the-money, fixed-plan, employee options, when in fact they had not. This "papering" of the option transactions therefore appeared as though no compensation cost needed to be reported.

Generally, auditors thought that option practice was a low-risk (non cash) area and relied on the client company's records without attempting to verify if such records reflected what actually occurred. We think a clear lesson has now been established. However, we remain concerned whether auditors were actually complicit, turning a blind eye because of client pressures or because it seemed like "every one was doing it" (backdating). We have little doubt that auditors today will acknowledge that backdating typically failed to meet the criteria of APB Opinion 25, that is, recognition of zero expense only for at-the-money options.
It is now the case in over 100 countries around the world that follow either U.S. GAAP or International Accounting Standards rules, that backdating, without expensing of the full fair value of the options, would constitute a violation of accounting standards. Whether because of these new option expensing rules, Sarbanes Oxley, the public furor over backdating or some combination thereof, we must now expect that proper audit procedures would demand a closer look and verification of these options and restricted stock practices. We expect this will be facilitated by the SEC’s new executive compensation disclosure requirements.

LINGERING CONCERNS

As we noted above, the companion practice of spring-loading options grants should be further scrutinized. This involves the gaming of grants around the release of material non-public information. Studies suggest this has been rampant for many years and it happens regardless of whether grant dates are fixed annually or at the discretion of management or directors. The protections offered by the Sarbanes Oxley accelerated Form 4 filing, does not address this. While the latest executive compensation disclosure requirements of the SEC do require a full review and report by the compensation committee on any spring-loading activities, it does not prohibit them. We would encourage a closer look at whether officers and directors in control of the option granting process should be barred from participating in any spring-loaded grants, just as they would be prohibited from trading in any other company securities while in the possession of inside information.
We have one additional concern. We believe that one facilitator of backdating was accounting rules that failed to result in fair value expensing of the cost of the options. As we have said, auditors apparently failed to consider such off-balance-sheet (OBS) items of sufficiently high risk to warrant full scrutiny and thorough audits of the option grants. Many more items, several of considerable size relative to most companies' balance sheets, remain off-balance-sheet and unexpensed, and reported if at all, in the notes. We would hope that auditors would learn from the lessons of the 2001-2002 corporate collapses involving large OBS transactions and the backdating/spring-loading problems currently receiving scrutiny and tighten their procedures to make certain that these receive the same attention as items required to be expensed.

CONCLUSION

We commend the members of the Committee for your continued attention and leadership on this unethical industry practice. In summary, we encourage three further steps.

1. Consideration of a possible ban on spring loading for named executives and directors.
2. A closer look by auditors and regulators for any irregularities in the granting process used for restricted stock.
3. A bolstering of audit procedures to include a closer review of any other off balance sheet items posing similar risks of being misreported.

Our markets can ill afford further lapses in the ethics relating to executive compensation or the integrity of financial reporting. We have been down that market-paralyzing road before.
EXHIBIT "M-7"
Russell Read  
Chief Investment Officer  
California Public Employees' Retirement System  
Testimony Prepared for the Senate Banking Committee  
September 6, 2006

Chairman Shelby, Senator Sarbanes and members of the Senate Banking Committee, I am pleased to be here today to provide an institutional investor’s perspective on the important topic of stock option backdating and spring loading.

I am Russell Read, Chief Investment Officer with the California Public Employees' Retirement System (CalPERS). As you know, CalPERS is the nation’s largest public pension system with more than $209 billion in assets. We have long been a voice for corporate governance. We are committed to executive compensation reform, to full disclosure and transparency of financial information, and to director accountability.

The recent allegations around secret and even fraudulent backdating of options are disturbing. We appreciate your leadership, Mr. Chairman in calling for this hearing and for your personal commitment and the commitment of the Senate Banking Committee toward addressing this problem.

CalPERS believes that as part of a good executive compensation policy, stock options are appropriate. They align employees’ interest with that of the shareowners. But when options are hidden from view, and when the option awards themselves do not tie to performance, it creates a serious problem.

As you know, CalPERS size does not lend itself to selling our stocks in troubled companies. As a large institutional investor, we don’t have the luxury of not showing up for the ballgame. Baseball fans can choose to stay home, but as the steward for so many public servants who depend on us for their retirement security, we cannot.

If we are out of the ball game, we can’t produce the investment returns that cover $3 of every $4 of our people’s retirement benefits.

When an executive takes stealth payments that we can’t trace, when companies make false statements and omit material facts concerning backdating of option grant, billions of dollars can be inappropriately given and once the truth of such option grant practices are made, it can cause the company’s stock to fall precipitously. This directly hurts the retirement security of ordinary Americans. In CalPERS case, we’re talking about clerks, custodians, school bus drivers, firefighters, and highway repair people, for example.
Since this issue has come to light, an unprecedented number of late filings with the SEC have occurred, which of course, delays disclosure to shareowners.

Secondly, these late filings are often considered to be technical violations of the conditions of borrowing, and that is costing companies too.

Last month, the Wall Street Journal reported that some bondholders are calling in their loans or demanding payment or large fees in exchange for an extension of their default deadlines. As many as two dozen companies were reported to have faced this dilemma over the past 18 months, and some had to pay multi-million dollar fees.

Even more astonishing, as the Wall Street Journal also reported, we are now learning that as stocks sank after the terrorist attacks of September 11, scores of companies rushed to issue options to top tier executives when the stock market had reached its post-attack low on September 21, 2001.

Now comes a cascade of class action and shareowner derivative lawsuits.

Once again, this scandal has brought back a number of fundamental corporate governance questions, such as:

1. Are Boards condoning this behavior?
2. If not -- and the Boards are themselves surprised to learn of questionable backdating -- then the question is where was their oversight?
3. It raises questions about adequate internal and external auditor controls? Are the auditors being vigorous enough in their examination of a company’s option granting practices?
4. And finally, investors want to know if illegalities are occurring, will the wrongdoers be swiftly and aggressively prosecuted, and will they be held accountable with civil and criminal penalties where appropriate?

Mr. Chairman, you hit the nail on the head when you said that if the public is to maintain full confidence in our public markets, the appropriate action need to occur.

Over the last two months, we have approached 42 portfolio companies under investigation by the SEC. We have asked that companies perform independent investigations and that they publicly disclose all findings resulting from such investigations, regardless of the outcome.

We have urged company boards of directors to develop policies that disclose how stock option grant dates are established and then publicly disclose those policies in company financial and proxy statements.
We want Company Boards and Compensation Committees to conduct an audit of their executive compensation plan administrator to be sure they are acting in full compliance with their directives.

And we strongly believe something needs to be done to be sure that company resources are not used to satisfy the tax and legal liability of executives implicated for this kind of wrongdoing. Such an inappropriate use of corporate assets hurts shareholders twice – once by the fruits of such backdating, and the other when they are allowed to use company assets to defend their actions.

We urge the Committee to call on the SEC to continue to investigate, and to aggressively prosecute wrongdoing.

We believe the SEC has the authority it needs to solve this problem. But we think they need to be more aggressive in enforcing rules for the filing of Forms 3, 4 and 5. SEC rules require company stock sales to be reported on SEC Forms within two days of the date of execution. SEC rules also require two-day reporting of certain transactions between employee benefit plans by officers and directors and that transactions involving stock options such as grants, awards, cancellations and re-pricing be reported in the same time frame.

We welcome the Public Accounting Standards Board's help by providing greater oversight of auditing practices pertaining to option grants. Their July 28th practice alert is very beneficial, and we welcome their continued oversight.

I would like to close by giving our view of the issue of spring loading of options.

We believe the SEC's requirement that an issuer disclose its option grants policy will have a positive effect. It should mitigate the activity of spring loading options in the future. However, should this not prove to be the case, we recommend that the SEC take additional steps to ensure that option grant practices are carried out in a systematic fashion, unaffected by the timing and release of material non-public information.

To sum up, we are going to do our part as active shareowners to hold Boards of Directors and Compensation Committees accountable. We will work with the SEC and the PCAOB in whatever way they deem helpful, and of course, we stand ready to assist this Committee by providing additional information. Finally, on behalf of the 1.4 million public servants we represent, I want to thank you once again, Mr. Chairman for all that you and this Committee are doing to restore the public trust in our financial markets.

I would be pleased to answer any questions.