This 3DAdvisors Report Covers:	
	Insider Trading: Insider Trading Behavior
	Accounting: Quality of Earnings Issues
✓	**Governance:** Corporate Governance Issues

Change in Option Behavior Not to Be Ignored
Affiliated Computer Services, Inc. (NYSE:ACS) Update

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Affiliated Computer Services, Inc. is a global company delivering comprehensive business process outsourcing and information technology (IT) outsourcing solutions, as well as system integration services. The Company operates in three business segments: commercial, federal government and state and local governments.

Summary of 3DAdvisors Findings for ACS

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Discussion of 3DAdvisors Findings

Last November, the SEC began investigating certain practices of several well known tech companies related to the timing of stock option grants. It has been alleged that the companies involved had timed their grants to insiders while share prices were low and in some cases just prior to the release of positive news that resulted in near-term rallies in the stocks. Insiders can potentially profit from such activities if the share price remains high until the options become exercisable (i.e. vest), because the strike prices have been manipulated to be established at lower prices. Among the companies that have disclosed they've been contacted by the SEC regarding the timing of option grants are Cisco Systems (NASDAQ:CSCO), Siebel Systems (NASDAQ:SEBL), and Analog Devices (NASDAQ:ADI), among others.

As you might imagine, this type of behavior is of great interest to us. We consider this practice to effectively be insider trading in derivative securities if executives have non-public information that they have acted on and ultimately profit from. Add some emphasis to this if the company also changes or modifies vesting schedules or other restrictions that allow executives to gain quicker access to the underlying shares.

Some might argue that since most options do not typically begin vesting until at least one year from the grant, the outright accusation of "insider trading", with regards to such behavior, is probably a bit too strong in a general sense. We would counter, however, that it is a form of insider trading if, for instance, the news on the horizon was truly material, such as a takeout at a high premium. At the very least, we have always viewed instances where companies grant options out of phase with their normal practices, and when their shares are trading at low prices, as clear-cut examples of gaming the compensation system and an important governance behavior.

Governance: Change in option behavior not to be ignored

In this context, we find some recent changes in options-related behavior at ACS to be quite interesting, and we think the Commission would find it interesting as well. Until recently, option grant practices at the Company were one of the few areas that did NOT interest us. This is because the Company has since the adoption of the 1988 Option Plan (predecessor of the 1997 Stock Incentive Plan) placed additional restrictions on vested options, not permitting the exercises for an additional 5 years after the respective grant date. This all changed, however, on February 5th, 2005 when the ACS board approved changes in the "exercisability of options". These changes did away with the five-year holding periods and substituted them with retroactive vesting schedules that, in effect, made the majority of previously-granted options suddenly exercisable. This change was initiated across the board, for all options series. We also note that this was a material event that was not disclosed in an 8-K, but rather was slipped into the subsequent 10-Q and then later reported on the Form 4s of the respective insiders.

At first, we expected to see a slew of option exercises, and subsequent sales, once these gates opened. But any such activity has yet to materialize. Possibly, we thought, with ACS shares trading in the low-$50's, down from their near-term high of almost $60 last November, insiders may be waiting for a rally before punching out some of their newly-accessible shares. Or perhaps, there may be a negative catalyst brewing which forced hesitation from insiders, fearing that they may be accused of trading ahead of news.

Our theory of a near-term negative catalyst having caused insider hesitation to sell, however, was significantly altered by the emergence of a slew of out-of-phase option grants, to five key insiders, on March 18th. These large grants (see Table 1) were the second round for these individuals in F/Y 2005, something we don't see at ACS under the 1997 Stock Incentive Plan, the plan under which the grants were made. With the exception of 2001, when two named executives received a second grant during that fiscal year in what appears to be a special situation, 2005 is the only time when the Company has granted options a second time in the same F/Y. Interestingly enough, this out-of-phase grant occurred just two days after the Company announced its purchase agreement to buy Mellon Human Resources & Investor Solutions Inc. from Mellon Financial.

From Figure 1 below, it is quite clear that ACS typically issues options to its executives early in each fiscal year (typically in the July/August timeframe or a touch later) and only issues them once in each fiscal year. In F/Y 2005, the Company issued in July, as it typically does, but then chose to issue new grants in March, with the stock price lower than when the earlier grants were made.

It is quite evident to us that ACS chose to issue these out-of-phase options for some specific reason. It is also likely that, if management suspected that a near-term negative catalyst was looming, it would have waited until lower prices before granting these new options to themselves.

Figure 1. ACS Daily Closing Price and Option Grant Dates for Fiscal Years 2000-2005. Source: Reuters and ACS SEC Filings. Blue diamonds are the dates upon which option grants took place in each fiscal year through 2004. Green diamonds are the two dates where option grants were made in FY 2005.

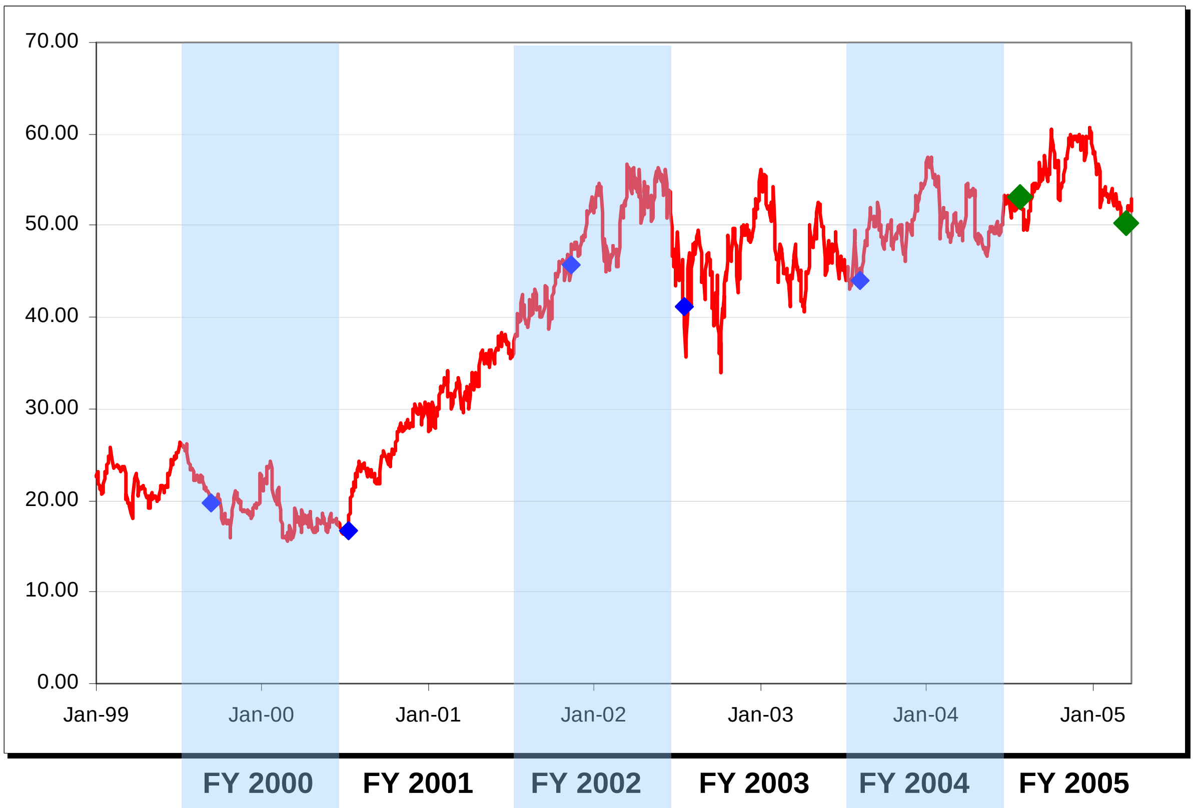

Table 1. Option Grants to Named Executives During 2005 Fiscal Year. Source: ACS SEC Filings.

Named Executive	Title	Options Granted in FY 2005	
		July 2004	**March 2005**
J. Rich	CEO	100,000	400,000
M. King	Pres/COO	75,000	300,000
W. Edwards	CFO	50,000	150,000
J. Rexford	EVP	25,000	100,000
L. Blodgett	EVP	100,000	200,000
Strike Price		$51.90	$50.25

We feel that this recent behavior illustrates yet another specious practice by ACS, this time in the Governance area. We are compelled to report this as the combination of accelerated vesting (without any of the affected insiders exercising newly accessible options), and the timing element evident in the recent option grants provides a clue that Company management may be thinking that, for the near term, ACS shares may work a bit higher, as they have done no less than four times in the past three years after they have moved to the lower end of their trading range. This in no way alters our view that ACS represents one of the most interesting examples of egregious insider, accounting and governance behaviors that we have seen, and clients are still well advised to keep a sharp lookout for the emergence of any new catalysts.