Brocade's Stock Option Backdating Scheme

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Executive Summary

In this case study I will examine the case of Brocade backdating stock options between 1999 and 2004 to enrich employees and senior executives. The SEC investigated the company and then brought charges against their CEO and other executives during that time. Those resulted in a $7 million fine for the company and criminal convictions of the CEO and VP of HR. The penalties included jail time and hefty fines. This was an important and historic win for the SEC and Justice Department since it was the first criminal trial over backdating of stock options. This trial marks the end of CEO's thinking that this is practice has no consequences, and that they can easily get away with it.

Introduction

When a company decides to grant stock options to employees, they have two options. They can either grant “in-the-money” stock options which means the employee receives the stocks at a lower purchase price than the current market price or they can grant “at-the-money” stock options which means the employee receives the stock at the current market price of the day the stock was granted. This “at-the-money” option is what Brocade mostly used and what allowed them to stay under the radar for so long. Stock options backdating refers to a practice in finance where you change the date of when a stock option was originally granted to a day at which the stock price was lower. This allows you to make the stock more valuable because the price at which employees receive the options is fixed to the current market price. So, if you see that your current stock price is high and you currently have stock options, then you can illegally backdate them to extract more value out of them since the cost of you acquiring them is going down. I am specifically focusing on the case of Brocade performing this practice because they were the first company ever to seriously get investigated by the SEC for doing so.

Body

Brocade went public in May 1999 and quickly experienced substantial business growth. During that time, the job market was extremely competitive, and it was hard to find good people in the tech space according to Brocade’s management at the time (DOJ, 2006). To incentivize qualified personal to work at Brocade, the company starting using stock options packages for new hires. This seemed to work well, and to actually retain those new employees since the companies were competitive and trying to lure qualified personnel from each other Brocade started to commit it's first offense of backdating stock options. Employees of the HR department would start to backdate employment offer letters of the new hires to earlier dates which allowed them to then also backdate stock options that were granted to these new hires to earlier dates before their employment. The market price of the stock on these days was lower which allowed them to get even more value out of their stock options. The CEO at the time Gregory Reyes then had the idea to also use this same scheme for himself and other employees at the company especially high-level executives. Reyes went in front of the board of directors and asked to be granted sole authority of the "Compensation Committee for the Board of Directors". This request was granted and allowed Reyes to on his own authority grant stock options to employees as he saw fit. The only exception to that rule was himself and certain high-level executives which needed board approval to get stock options which were approved whenever requested. Since this scheme uses "at-the-money" options the reporting requirements are really light which allowed them to easily get away with it from 1999 to 2004. "At-the-money" options need to be reported 45 days after the end of the fiscal year at the latest (DOJ, 2006). This allowed the HR department under the direction of its VP Stephanie Jensen to start a yearly activity of finding out the historical lowest market price of the fiscal year. Once those dates were identified, the department started to backdate Compensation Committee meeting notes to those days since the price of the option is set at the market price of the day they were granted on. Since they only had to report this at the end of the fiscal year no auditing or financial firm found out about this since the paperwork looked to be accurate, and since Reyes was the only person on the committee it was easy for him to sign off on the faked meeting notes. This became such common practice over the years that later on during the SEC investigation, an HR department witness said they would routinely print out historical low closing prices for the stock and circle them and give them to Jensen to know which dates to backdate meetings and statements to. During the investigation Jensen states that she even mentions to Reyes that pricking the absolute lowest date every year could start to look suspicious (DOJ, 2006).

In 2005 the SEC and FBI started to investigate Brocade due to irregular findings in their financial statements, and probably due to the suspicious stock options granting meetings that always seem to happen on the day the stock was the absolute lowest which I mentioned Jensen warned Reyes about. Around that same time the independent audit committee of Brocade's board preliminary determined that Brocade and its auditors could not rely on any meeting notes or statements that were signed of by Reyes. Due to that the audit committee came to the conclusion of having to redo the financial statements for the fiscal years of 1999 through 2004. Since the committee had no way of knowing the actual dates stock options were granted because Jensen and Ryes changed all the dates, they had to use a special accounting method called "variable accounting" where the value of the stock is calculated based on the reporting period as an "in-the-money" fixed price. This caused the following impact on Brocade's financial statements:

> "(1) net loss from the 2004 fiscal year increased from $2 million to $32 million; (2) net loss for the fiscal year 2003 increased from $136 million to $147 million; (3) income from fiscal year 2002 increased by $60 million to $126 million; and (4) income for fiscal years 1999 through 2001 declined by a total of $304 million" (DOJ, 2006)

Due to the findings of the SEC's own investigation and the new financial statements by the audit committee, the SEC filled a criminal complaint against Brocade, its CEO, and its VP of HR in 2006. Just a few months later a grand jury indicted Reyes and Jensen of Conspiracy, Securities fraud, Mail fraud, Falsifying Books, Records, and Accounts, and Aiding and Abetting (Cheever, 2007).

The respective trials of Gregory Reyes and Stephanie Jensen started in 2007. Before the start of the trials Brocade reached a settlement in a separate civil case where they agreed to pay a $7 million fine but admitted to no wrongdoing (Fagel, 2007). After a week's long trial in Reyes's case a jury in San Francisco found Reyes guilty on all 10 charges, which was the first time a jury found an executive guilty over backdating of stock options (Horsley, 2007). The trial of Jensen was a lighter one as she only faced two charges of conspiracy and falsifying corporate records. In December 2007, a jury found her to be guilty of both those charges (Modine, 2007). Reyes was sentenced to 21 months in prison and had to pay a $15 million fine (Eaton, January 2008). Jensen was sentenced to 4 months in prison and had to pay a $1.25 million fine (Eaton, March 2008). Reyes filed for an appeal and won in a federal appeals court in 2009 due to misconduct by the prosecution. He was retried 2010 and another jury found him guilty on 9 out of the 10 charges this time (Sage, 2010). This time he got sentenced to 18 months in prison with the same fine of $15 million (Bailey, 2016).

Under the theory of white-collar crime and according to the textbook this type of crime is categorized as Corporate Crime. The executives acted on behalf of the organization in these cases and defrauded shareholders of the company. This type of crime may not be violent or hurt anybody directly but as we learned these types of crimes can cause indirect pains against innocent people and further causes the distrust of corporations in this country. According to our textbook: "75 percent of Americans had an image of corporate America as not good or terrible" (Friedrichs, 2012). Crimes like these further that opinion and that is why it is necessary for law enforcement and especially the SEC to continue uncovering these crimes and bringing them forward to charges and trials. From the actions of the executives, you can also tell that they were not too worried of being caught as it was standard business practice during the time and since they are committing a white-collar crime no one thought much of the consequences. Another sub layer of white-collar crime applies to this case referred to as Finance Crime. Even though Brocade is not a financial institution they still committed financial crimes by defrauding financial institutions and supplying them with falsified documents and financial statements. This plays into the same idea as Corporate crime that it causes the distrust of the financial markets if a company gets away with it because the stock market is open for everyone to participate and should be fair and equal.

Conclusion

In conclusion this case marks a historic win for the government and SEC specifically because it was the first time a company and its executives have been charged and convicted on charges relating to illegal stock option backdating. After this case, the SEC started investigating and charging many more companies relating to stock option backdating (SEC, 2011). This also showed the corporate world that stock option backdating is not something they can get away with anymore and probably caused many companies and executives to change their ways seeing how they could now be held accountable for it.

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