financial executives international
August 2006

New SEC Options-Pricing Rules Aim at Clarity, Transparency

By Mark Rosen

New SEC rules focus on shining a more intense light on the approval and administration of stock option programs rather than outlawing specific practices – making irregularities a sin of commission, rather than omission.

Longtime questions about the timing and pricing of executive stock option grants erupted into major controversy in March when triggered by a front-page Wall Street Journal article that quickly engulfed dozens of companies. The controversy came to a head just as the U.S. Securities and Exchange Commission (SEC) was nearing completion of its biggest overhaul in more than a decade on rules governing disclosure of executive compensation. Regulators quickly added option pricing as an additional area of consideration, alongside the agency's separate investigation into potential civil and criminal wrongdoing. Given growing criticism that the link between executive pay and corporate performance is too tenuous, the idea of companies manipulating the timing of option grants so that executives could take advantage of lower share prices struck a new nerve.

In approving new proxy disclosure rules on July 26, 2006, the SEC recognized what is sometimes lost in the uproar: that irregularities in option pricing practices range widely – from the illegal to the unseemly to the merely sloppy. A week after the agency filed charges of security fraud against executives at Brocade Communications Systems Inc., the agency emphasized its intention to avoid the use of loaded terms such as "backdating" or "springloading," and to not editorialize about different grant practices.

Rather, the agency chose to focus on the quality of board oversight. It di so by requiring in various sections of the proxy not just additional disclosures of the value of options, but also explanations as to why grants were made, how prices and grant dates were chosen and the extent to which executives were involved in the grant process. By requiring companies to

document their practices and their thinking, the new disclosure rules essentially make option irregularities a sin of commission, rather than omission. Both deliberate and accidental problems of option pricing are addressed – the former, because companies would be in the position of having to file false information and the latter, because errors and irregularities are less likely to be overlooked.

Pricing, the 'Spirit of Good Governance'

Options give executives the opportunity to purchase stock at a fixed price (usually the market price on the date of grant) for a period of time (usually up to 10 years). In theory, these "fair market value" option programs put executives at a similar investment risk as current shareholders, since the gains for both parties are tied to future increases in the stock price. The lower the exercise price at which the option (relative to the then-current fair market value) is awarded, the more likely that the option can be exercised at a profit.

Backdating option grants, or selecting preferential grant dates, to provide additional upside gains to executives – while questionable from a governance standpoint – isn't necessarily a problem, providing that 1) companies adhere to appropriate tax, accounting, disclosure and insider trading regulations; and 2) that the firm's shareholder-approved equity plan permit exercise prices that are less than the fair market value of the stock on the date of the grant.

At issue is how closely companies hewed to these requirements, as well as whether pricing policies were in the spirit of good governance. The controversy hinges on whether some companies improperly set option exercise prices, either by backdating grants to the date of a known share-price low or by making an option grant immediately in advance of an event likely to boost share prices, a practice known as "springloading."

For strategic reasons, companies may want to assign some option grants an exercise price that is lower than the share price on the actual day of the grant. However, they are generally prohibited from determining grants dates on the basis of non-public material knowledge likely to affect share prices.

Additionally, companies are required to treat such grants as essentially "discounted" stock options, with a below-market share price and take the required accounting charge. The SEC alleges that many companies did not disclose the lag between the grant approval and grant effective dates in order to avoid that cost, or either took advantage, or managed the release, of non-public information in choosing grants dates.

Impacts of the New SEC Rules

The likely impacts of the new rules – aside from generating a great deal of additional paperwork – include the following:

- **More barriers to option backdating.** Ironically, recent changes in the regulatory

  environment have reduced the opportunity – and some of the motivation – for companies to engage in option pricing irregularities. In 2002, Sarbanes Oxley reduced the filing period for companies to report new option grants to two business days so that investors would be informed in a timelier manner, which also made it easier for interested investors to compare grant dates with share prices. In 2004, IRS Section 409A began treating discounted options as deferred compensation, subject to immediate taxation, with the result that many employers choose to grant options at fair market value on the date of grant, rather than subject employees to potentially early taxation.
  Most recently, new accounting rules require that options issued at fair market value and full-value grants both must be charged to earnings, eliminating an incentive to make sure that the grant date value matched the strike price to avoid an earnings charge. Also during this time period, corporate governance advisors began requiring equity plans to specifically require that options be granted with strike prices no less than the fair market value on the date of grant. Many plans did not require this prior to this change in the governance perspective.

- **Boards play defense.** Nevertheless, the SEC recognized the need to address

  problematic option practices that have dominated headlines since the spring and push companies in the direction of good governance. While deliberately not passing judgment, expanded disclosure puts compensation committees on the defensive if they choose to provide employees with discounted options or grants timed to favorable market conditions.
  Companies must state their timetable for making grants and, if they lack such a schedule, to explain how the grant dates are set. They must state whether grants were ever delayed, accelerated or coordinated with the release of material non-public information that would affect their value and, if so, explain why. Additionally, if the effective date of the grant is different from the date on which the committee approved the grant, both dates must be disclosed. Lastly, companies must specify whether option exercise prices for each grant matched the closing share price on the grant date, and if not, show the price difference and explain the methodology used.
  The additional information will be provided in various places in the proxy, both quantitatively in the form of additional tabular disclosure and in narrative form as part of the Compensation Discussion and Analysis (CD&A), a filed document that is a main focus of the SEC's new rules.

- **Information is power**. While the SEC has made no move to give shareholders a more

  direct say in compensation decisions, the agency made clear that it wants to increase the ability of investors to evaluate programs by providing additional disclosure. The release of more detailed pay data, including more specific information on the terms of individual option grants, is likely to provide ammunition for institutional investors, unions, the media and other frequent critics of executive compensation practices. Moreover, because the more detailed CD&A will be a filed document, companies face the possibility of increased liability if their more detailed version of stock option practices is subsequently challenged. Nevertheless, some investors were disappointed, saying that they wanted something with more teeth.
  Mind the knitting. It’s clear that compensation committees will become much more involved in the nitty-gritty of stock option plan design and administration than has historically been the case. Among the questions members must now address in the proxy is the role of the compensation committee in approving and administering programs and plans, as well as whether the committee delegated any aspect of the actual administration to anyone else.
  Rather than just approving new grants to individuals and leaving the logistics of putting together and issuing awards to employees, members will need to monitor the entire

process to ensure compliance and protect them from potential liability. While certain companies deliberately manipulated grant prices to enhance their value to executives, at many others the irregularities were the inadvertent result of administrative sloppiness that did not necessarily redound to the financial benefit of recipients.

More distance from management. Already under pressure from shareholders to act independently of management, expanded disclosure gives compensation committees an additional incentive to reduce the role of management in compensation decision-making. Along with having to specify in the filed CD&A whether the committee delegated any aspect of option program administration, the new rules require members to specify the role of executive officers in the design and administration of the company's option programs.

One likely change: until now, it has been left to management to recommend specifically when option grants approved by the compensation committee should be made. Given increased attention to the potential for management to use non-public information to set grant dates and increase the value of awards, it is expected that committee members will take a more active role in the administration of awards.

- **The daily number. The** SEC zeroed in on the commonly used concept of "fair value on

  the day of grant," requiring additional disclosure if the option exercise prices differ from the closing market price on day of grant, which it deemed the commonly used standard. In fact, accounting and tax rules allow more flexibility in deciding grant date value and many companies price grants based on the average share price on the grant date. Going forward, companies may prefer to structure their plans, and revise existing plans, based on the final share price to avoid the need for additional disclosure.

- **Rush job.** In light of the need to provide an explanation for grant practices, Pearl Meyer

  & Partners has been urging clients, since release of the preliminary rules in January, to address the wide-ranging process and program changes needed to comply with the new disclosure mandates. Companies that have done so will have less trouble accommodating to the extensive documentation required to meet the additional disclosures aimed at option timing and pricing practices.

  Those firms that have not begun the process will find themselves under intense pressure in coming months to collect the information needed. Some will want to amend existing equity plans to incorporate more governance-friendly practices, such as adopting pre-determined grant dates and/or grants dates timed to provide management and investors with relatively equal access to corporate information, rather than having to provide extensive explanations in their proxy of the alternative practices.

- **Options will survive.** Stock option use has steadily declined in recent years in the face

  of outrage over mega-grants, concerns that options don't promote a long-term performance perspective and the advent of mandatory option expensing, which eliminated the financial advantages of stock options. Full-value share use has increased over the same period, with interest slowly growing in the use of restricted stock grants based on the achievement of performance goals that are unrelated to share price.

  Pearl Meyer & Partners does not agree with some predictions that option use will suffer in the wake of expanded disclosure or what is certain to be continuing controversy over how exercise prices at dozens of companies were set. When properly designed and administered in combination with other stock and cash incentives, options remain a key element of executive compensation programs.

- **Less flexibility.** Imposing a more formalized option grant structure unavoidably will

  reduce companies' flexibility to provide equity incentives in changing circumstances. Chief executives are likely to be allowed less latitude by their boards to make lucrative grants to new employees in a competitive hiring market. On the other hand, the new rules

put all companies on a level playing field.
Companies that don't already have a specific schedule for issuing options grants must adopt a grant date calendar, or explain to shareholders why they have chosen not to do so. Many firms will deliberately schedule grants to be made one or two days after an earnings announcement, which will provide investors the opportunity to make investment decisions based on the same information available to management.

Taking the approach that sunshine is the best disinfectant, the SEC has chosen to shine a more intense light on the approval and administration of stock option programs rather than to outlaw specific practices. To be sure, a few bad apples may figure out a way to game the system. However, the new rules go right to the heart of the option pricing and, as such, provide an strong inducement for better governance.

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