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## Avoiding the Next Controversy

*Updating Practices to Prevent Option Backdating and Related Practices*

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Announcements of option backdating investigations and enforcement actions by the Securities and Exchange Commission (SEC), complaints filed against officers, including general counsel, and directors, subpoenas received from the U.S. Attorney's Office, restatements of financial statements and resignations of executive officers and directors continue to make headlines and plague public companies struggling with these issues.

As this option backdating controversy continues, updating corporate governance practices is important in order to avoid the costly consequences of being implicated in allegations of option backdating, spring loading (i.e., granting of options right before the positive information about the company is announced) or bullet-dodging (i.e., granting of options right after the negative information about the company is announced).

This article discusses several simple steps that public companies can take from a corporate governance perspective to put controls and other changes in place to prevent these issues in the future.

### THE COMPENSATION COMMITTEE

In light of the new SEC compensation rules effective Dec. 15, 2006 which require significant additional disclosure

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on option granting practices by public companies, the compensation committee of a company's board of directors must take the lead on the review, revision and enhancement of corporate governance practices related to option grants and, in particular, the procedural process undertaken to make grants. Generally, the specifics of an option grant should be either determined by the compensation committee or recommended by the compensation committee for the approval by the full board of directors.

Members of the compensation committee should be independent and have some prior experience in dealing with the compensation issues. Under the new SEC compensation rules, public companies have to disclose those members of the compensation committee who are not independent under applicable exchange listing requirements. Although there are no requirements related to the number of directors that should comprise the compensation committee, the committee should consist of at least three directors to avoid decision-making deadlocks.

In addition, at least one committee member should be knowledgeable in the area of executive compensation matters. The accounting, tax and legal aspects of the compensation of direc-



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tors and executive officers become more and more complex and require the input of a director who is a compensation expert, similar to the role of an audit committee financial expert. In the absence of an expert serving on the compensation committee, the committee should have the ability to retain expert advice from an independent outside consultant.

Most compensation committees have already adopted a charter. The provisions of the charter should be reviewed to analyze the scope of the committee's authority with respect to option grants. It is recommended that the charter be amended to specifically provide that the compensation committee has the

authority to retain and compensate independent compensation experts. If the committee does not have a charter, it should consider adopting one to establish its responsibilities and procedures, as well as to avoid the awkward disclosure required under the new SEC compensation rules that the compensation committee does not have a charter.

Members of the compensation committee should understand the documents that are utilized from a legal perspective in connection with the option grants. The provisions of stock option or other equity plans under which the company grants options should be carefully evaluated to determine the following:

- Who is authorized to administer the plan (the board of directors or the compensation committee)?
- Who is eligible to receive option grants under the plan?
- Does the plan provide for the delegation of authority to an officer of the company with respect to certain grants (i.e., which officers and what authority do they have)?
- Can options be granted at an exercise price that is different from the market price on the date of the grant, and how is market price defined in the plan?
- Are there special provisions governing the grant of options to directors?

In cases of options awarded to newly hired employees or newly appointed directors, such option grants generally cannot be dated the date prior to the first date of such person's employment or service on the board of directors unless the plan governing such option grants applies to future employees and directors. Most plans only provide for grants to current employees and directors.

Specifics of option grants are also often contained in the employment agreements with executive officers. Such employment agreements should also be analyzed for compliance with the terms of the existing equity plans approved by stockholders. The compensation committee should meet with counsel to discuss these documents in order to provide members of the compensation committee with a thorough understanding of what is involved in granting an option.

Under the new SEC compensation rules, public companies will have to disclose the scope of authority of the compensation committee as well as whether it may delegate its authority to other persons. If the grant of options to non-executive employees of the company is delegated to the chief executive officer or other senior executive, a practice that is not recommended (assuming that the terms of the plan permit such delegation), the compensation committee should carefully spell out the boundaries of such delegation and avoid approving bulk grants of a certain number of options that are later allocated by the senior executive officer.

The unintended result of such practice can lead to the option being considered granted at the time the grant is being allocated by the executive officer, with the exercise price set at the value of the stock on the date of the board action (i.e., a backdated option). If the compensation committee chooses to use the delegation of authority, such delegation should be in writing and should make clear the following:

- Whether the senior executive officer is authorized to grant options or just recommend the names of the grantees and the number of options leaving the final decision regarding the grants to the compensation committee; and
- What type of employees can be granted options by such executive.

In case of the delegation of authority to make certain option grants, the compensation committee should regularly review the documentation related to the grants made by the senior executive officer, who should report to the committee at least once every quarter regarding the options grants during the interim period.

There are certain periods throughout the year when the company's normal business cycle and reporting schedule suggest that insiders are more or less likely to be aware of material nonpublic information about the company and its securities (i.e., prior to the end of each fiscal quarter and the announcement of earnings, especially year-end earnings). Granting options during such periods can lead to claims that the options grants were made at this time to get the lowest exercise price (i.e., bullet-dodg-

ing or spring loading).

Once the material nonpublic information has been publicly disclosed, a reasonable time should elapse for the purpose of permitting public dissemination and evaluation of the information before the options may be granted. Generally, an "open window" is a period of approximately two weeks beginning two business days after the public dissemination of the information and lasts until the end of the company's fiscal quarter. The compensation committee should develop a policy for granting options during the company's "open window" periods, provided that during such periods, the compensation committee is not otherwise aware of material nonpublic information to avoid allegations of spring loading or bullet-dodging.

Under the new SEC compensation rules, public companies, excluding small business issuers, will be required to include a new table in their SEC filings disclosing, among other items, the following:

- The grant date for option awards as determined under Financial Accounting Standards Statement No. 123R, which is generally the date on which the decision to award an option is made, provided such decision is promptly communicated to the recipient of the award;
- The date on which the compensation committee (or another committee performing the function of the compensation committee or the full board of directors) takes action to grant options if such date is different from the date of the grant;
- The per-share exercise price of the options granted; and
- The closing market price of the security underlying the option on the date of grant if the exercise price of the option is less than the closing market price of the underlying security on the date of grant.

The "Compensation Discussion and Analysis" required under new SEC compensation rules should include the disclosure of:

- Whether the company has any program to time option grants to its executives in coordination with the release of material nonpublic information;
- How such program to time option

grants to executives fits in the context of the company's program with regard to option grants to other employees;

- The role of the compensation committee in approving and administering such a program; and

- Whether the company has timed, or plans to time, its release of material non-public information for the purpose of affecting the value of executive compensation.

In order to provide this detailed analysis in SEC filings, the compensation committee has to carefully and accurately document the policies and procedures applicable to option grants and review prior grants for compliance with these policies.

The compensation committee should keep abreast of all new developments in the executive compensation area, including changes to the laws, rules and regulations imposing new requirements related to option grants. This can be accomplished through the committee "expert," or by hiring compensation professionals and attorneys familiar with the accounting, tax, SEC and exchange rules related to option grants.

## **THE BEST DEFENSE**

A properly documented grant is the best defense to option backdating or

other allegations. Generally, backdating option grants is not illegal as long as the backdating is properly disclosed and accounted for. Therefore, if a company is permitted under the terms of its option plan to grant options at the exercise price that is not the same as the market price on the date of the grant, there should be no backdating issue, provided the information is properly disclosed in the company's SEC filings and the appropriate tax and accounting treatment is utilized. Problems arise when the company either intentionally does not properly disclose and account for the backdated option grants or does so due to poor record-keeping and general informality of taking corporate actions.

The corporate secretary or other designated member of the compensation committee should be in charge of properly documenting all actions taken at meetings in the minutes, which then should be filed in the company's record book. Minutes should be reviewed by corporate counsel familiar with the option granting rules and other requirements to ensure all appropriate steps are taken and correctly documented.

Usually, under the state corporate law and the company's governing documents, a committee of the board of directors, as well as the board of directors, is permitted to take actions by writ-

ten consent in lieu of the meeting. If some directors abstain from voting due to a disqualifying interest in the matter (for example, options are being granted to that particular director), then the action can not be taken by unanimous consent. Moreover, under most state corporate laws, the action by written consent is effective when the last signature to that consent is received, even if the consent is dated as of a prior date. Therefore, the date of the option grant may turn out to be later than anticipated by the company, which would result in a backdating issue. Avoid this problem by using telephonic or in-person meetings to make option grants.

## **CONCLUSION**

Board oversight over the process of option granting is critical. Even if the authority to grant options is delegated to the compensation committee, the board of directors must oversee the option granting process, as the board is the "gate keeper" of all corporate actions. The written minutes of the meetings of the compensation committee should be submitted to the board, and the committee should make reports at board meetings at least once every quarter or upon each particular grant of options or other compensation. •