



## RECENT DEVELOPMENTS IN STOCK-OPTION GRANT PRACTICES



August 4, 2006

To our friends and clients:

In July 2006, several executives were hit with federal criminal or civil charges for allegedly rigging stock option grants. According to the Securities and Exchange Commission (the "SEC") and the Justice Department, as of July 2006 there were approximately 80 companies under investigation. In fact, on July 20, 2006, the Wall Street Journal reported on four companies, including Brocade Communications Systems, Inc., Cheesecake Factory Inc., Petco Animal Supplies, and Juniper Networks Inc., all of which were involved in either internal or outside stock-option granting investigations.

At issue is whether executives manipulated option grants by backdating them to a point where the Company's stock was at or near a low point, boosting the value of those awards. Stock options are generally issued with an exercise price equal to the current market price, and therefore have no immediate value. By choosing an earlier date when the stock was lower, the options are instantly worth the difference between the strike price and current price. While stock options are used as an incentive for executives to boost a Company's performance and stock price, improper backdating can mean that executives reap big profits with no relation to their individual performance.

SEC Chairman Christopher Cox has told the Associated Press that "[the SEC] already learned that the problems are more than episodic. The apparently widespread nature of the problems is of serious concern" to the agency.

The media, principally starting with the Wall Street Journal, has identified dozens of suspect firms, as well as those under formal investigation and companies that have admitted to irregularities in the accounting of their option grants. According to a recent study done under joint collaboration by the Kelley School of Business at Indiana University and the Henry B. Tippie College of Business at the University of Iowa, an estimated 18.9% of unscheduled, at-the-money option grants to top executives during the period 1996-2005 were backdated or otherwise manipulated. The study found a higher frequency of backdating among tech companies and small companies.

The SEC's recent adoption of the Executive Compensation Disclosure Rules (the "Rules") is considerable and requires substantial discussion. It is therefore beyond the scope of this summary, although we have highlighted certain significant aspects of the new Rules following the Recommendations below. However, we believe that prior to tackling these new disclosure requirements, companies should follow certain guidelines in granting stock-options as a good corporate governance practice. Therefore, in an effort to assist our friends and clients and to alert them to potentially harmful practices, we have put together a summary of general recommendations, which may be followed, and which should be identified, well before the granting of stock-options.

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**Recommendations:**

Most importantly, Companies should not backdate options grants. More specifically, Companies should not date an option grant prior to the actual date on which the option was originally granted. Backdating options grants to a time when the Company's stock traded at a lower price can provide the options holder with an immediate gain; this practice is illegal. According to a Justice Department statement, the maximum penalties for criminal securities fraud are 20 years in prison and a fine of \$5 million.

Additionally, companies should not grant discounted options. Options that have an exercise price that is less than the fair market value of the stock on the date of their grant will be subject to Internal Revenue Code Section 409A (enacted under the American Jobs Creation Act of 2004), which imposes punitive income taxes on optionees who receive discounted options unless the options satisfy all of the requirements of Section 409A. Companies should implement policies that, absent extraordinary careful planning and deliberation, prohibit discounted option grants.

As a matter of good corporate practice, we recommend that option or compensation committees grant options at meetings (we encourage that these meetings take place after the Company's release of its quarterly or annual report). Granting options at meetings would make the granting process much more transparent. As SEC Commissioner Atkins remarked in a speech made on July 26, 2006, "[corporate Boards] should grant options at a time and in a manner that is consistent with their disclosures and that maximizes the interests of the existing stockholders." What is to be avoided at all times is the alteration, or "doctoring," of documents. Second, option grants should be contemporaneously and carefully documented by minutes or written actions by the granting committee or designated officer. At a minimum, the minutes or resolutions should name the optionees and state the number of shares subject to each option and its exercise price.

Further, in certain cases, a Board's approval for grants may not be deemed effective until the last Board member has signed the grant, and it has been delivered to the Company. As a result, in the event the stock price appreciates between the effective date and the date at which the fully executed consent is delivered to the Company, the delay could cause misdating and discounted option problems. Moreover, while most Boards and their committees are permitted to delegate the granting of options to other Board members, Company officers and other employees, care should be taken to ensure that the delegations comply with state law and plan provisions and are not haphazard. Otherwise, violations of these rules can create "ultra vires" grant problems, where officers act outside the powers granted to them by law or plan documents.

As previously mentioned, options grants should be thoughtfully deliberated and carefully executed, and preferably awarded on a consistent pre-determined date. In the event a grant must be made in a different manner, full documentation should be prepared and full consideration should be given to market timing issues and legal risks. Accordingly, new-hire grants are best awarded collectively on a regularly scheduled basis. In addition, we recommend companies implement automatic grants to independent directors on a fixed annual date. These grants should be part of a plan approved by the Company's shareholders.

Companies should also consider and review their D&O insurance policies, which contain many exclusions, exceptions, conditions and limitations. Companies and Boards should not assume that insurance carriers will cover the costs of option timing investigations and lawsuits. Companies with possible exposure should consider notifying their carriers.

Of course, companies should continuously review and reexamine their option grant practices and internal controls in order to minimize the risk of future problems. If you believe there may be issues with previously granted options or you need assistance in conducting such a review, please contact us. Additionally, for a detailed analysis of all the legal and regulatory considerations, companies and Board committees are welcome to consult with us on such matters.

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**New Rules:**

In addition to the foregoing, in order to address the issues raised in this memorandum and other concerns, on July 26, 2006 the SEC adopted new executive compensation disclosure rules. By and large, the new Compensation Discussion and Analysis requirements will pose the greatest challenge to compensation committees and corporate Boards. For example, the Securities and Exchange Commission has issued a sample Summary Compensation Table, which serves as the principal source of disclosure for companies. A sample of the recommended Summary Compensation Table has been set forth below for your review.

**SUMMARY COMPENSATION TABLE**

Name and Principal Position	Year	Salary (\$)	Bonus (\$)	Stock Awards (\$)	Option Awards (\$)	Non-equity Incentive Plan Compensation (\$)	Change in Pension Value and Nonqualified Deferred Compensation Earnings (\$)	All other Compensation (\$)	Total (\$)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
Principal Executive Officer	_____ _____ _____								
Principal Financial Officer	_____ _____ _____								
A	_____ _____ _____								
B	_____ _____ _____								
C	_____ _____ _____								

The above table, which has been refined from its previous version, will require compensation disclosure by the Principal Executive Officer, Principal Financial Officer, and the three other highest paid executive officers and directors (rather than the Company’s Chief Executive Officer and its other four most highly compensated executive officers, which was previously required). The Compensation Discussion and Analysis section will also require enhanced narrative disclosure about option grants to executives, and Companies will be required to explain their policies and actions, as well as their objectives in connection with the their compensation policies and decisions. Disclosure will also be required where a Company has not previously disclosed a program or practice of timing option grants to executives, but has thereafter adopted such a program or practice. For more information on the SEC’s new disclosure rules, we encourage you to consult with attorneys at Sichenzia Ross Friedman Ferencé LLP.



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The above discussion of the SEC's new Rules is a brief overview of the disclosure requirements Companies will be required to make in future reportings. In anticipation these challenges, Companies should make a point of reviewing and examining their current policies and choices in order to put in place structured compensation programs.

**Conclusion:**

Please note that the purpose of this memorandum is to alert you to steps the Company may take to comply with general corporate laws. **This commentary is for general information purposes only.** It should not be construed as legal advice or a legal opinion on any specific facts or circumstances. Because this memorandum is a summary, and because legal issues surrounding stock-option grants are of a relatively recent nature, we encourage you to consult with attorneys at Sichenzia Ross Friedman Ference LLP on any questions you may have about specific matters, including the SEC's recent adoption of Executive Compensation Disclosure Rules, and about specific corporate actions that the Company might be contemplating.

Very truly yours,

Sichenzia Ross Friedman Ference LLP

