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## Stock Option Grant Practices Under Scrutiny: The SEC Weighs In

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### Introduction

The processes by which companies grant stock options have generated a surprising string of front-page scandals over the past several months. Over 100 companies have become the object of publicly-announced investigations, two of which have resulted in criminal charges.<sup>1</sup>

Although the primary abuse under scrutiny involves a purposeful back-dating, or looking back at stock prices to pick the lowest price for a grant (and thereby maximizing the gain for those who receive the back-dated grant), other option grant practices more appropriately characterized as involving mis-dating have drawn scrutiny including those involving the following:

- Designating an earlier date as the grant date, or treating a date as the grant date when all prerequisites to a grant had not yet occurred;
- Determining a grant date based on the monthly low stock price; and
- Mis-dating the stock option through documentation that does not support the designated grant date, where (i) signatures required for unanimous written consent of the board of directors are not timely obtained or are incomplete; (ii) stock options are granted to new hires with grant dates earlier than the actual start date; and (iii) stock options are allocated to rank and file employees pursuant to board authority delegated to executive officers, significantly later than the actual board approval date.

Special scrutiny has also been leveled on companies that acted at the end of 2005 to accelerate the vesting of stock options to avoid future expense – the questions relate to whether the companies actually completed all formal actions before the start of 2006.

All of these questionable practices could trigger financial restatements, lost deductions under Section 162(m) of the U.S. Internal Revenue Code, disqualifications from incentive stock option treatment under Code Section 422, and violations of Code Section 409A that result in additional taxes

and penalties for optionees.<sup>2</sup> In addition, a back-dated, timed, or defectively documented stock option grant may and is likely to result in an exercise price that is below the fair market value of the underlying shares on the grant date. When this occurs, applicable accounting rules require a greater compensation expense. This has forced many companies to announce financial restatements, and others to delay the release of their financial statements.

The proliferation of option grant-making investigation has led independent auditors to become increasingly vigilant in their review of option grant practices, and the Public Company Accounting Oversight Board (PCAOB) to issue Staff Audit Practice Alert No. 1, “Matters Related to Timing and Accounting for Option Grants” which underscores the stringent audit procedures with respect to option grant practices. As a result, many independent auditors are now requiring executives of an audited client to certify to the absence of option back-dating and mis-dating problems.

### The SEC Weighs In

In August 2006, the SEC released final amendments to its rules relating to the disclosure of executive compensation.<sup>3</sup> Interestingly, the SEC adopted new disclosure requirements with respect to option grant practices, but did not formally address the accounting for options where back-dating and mis-dating are involved. However, the SEC Chief Accountant did recently provide guidance with respect to such accounting matters in a letter to Financial Executives International and the American Institute of Certified Public Accountants released on September 19, 2006, which is discussed below.

### SEC Disclosure Requirements

The SEC’s new executive compensation disclosure rules seek to make option grant-making practices transparent, and single out for explanation practices such as making grants immediately before a positive announcement, or immediately after a negative one. These practices have come under fire because executive enrichment results from the handling of inside information. For example, grants that occur just before

the announcement of positive news will enable executives to benefit from any jump in stock price. On the other hand, if the release of negative news delays a grant, the executive avoids the downside of any stock drop, and benefits from any rebound. The SEC's final rules do not expressly comment on these timing practices, but the rules do require detailed disclosure and explanation. The same is true if executive officers are involved in the grant-making process, or board or compensation committee authority is delegated. Transparency is fundamental to compliance with the new requirements.

### Compensation Discussion & Analysis

The principal vehicle for disclosure of option granting practices is the newly-required Compensation Discussion and Analysis, or the CD&A. Beginning with the 2007 proxy season, companies must specifically address matters relating to the timing and pricing of stock option grants, and in connection therewith, address a series of questions presented by the SEC:

- ▶ How was a particular grant date selected? Is there a particular plan or practice in place for timing the grant of options?
- ▶ What was the formula for selecting award terms such as exercise price?
- ▶ On what date did the Board or compensation committee take action to make grants? The stock option grant table must include a separate column showing the date of any Board or committee action that authorizes a date different from the date of their action.
- ▶ What information was taken into account for the grants?
- ▶ Were executive officers involved in the grant-making process? Were there delegations of authority? What role did the Board and the compensation committee take in the process?
- ▶ Did the company in any way time the making of awards to new hires?

### Tabular Disclosure

The new rules align disclosure with the accounting determinations made under FAS 123R. Under FAS 123R, the date of grant is determined by reference to when formal committee or board action is completed, provided that the award recipients receive notice of the award as promptly as practicable after the action is taken.

New required tabular disclosure includes the following disclosures with the date of grant in each case, as determined under FAS 123R:

- grants of stock options must be disclosed in the Summary

Compensation Table at fair value on the date of grant

- a separate table including disclosures of equity awards requires disclosure of dates of grant
- a separate column is required if the exercise price is less than the closing market price on the date of grant, showing the market price on the date of grant
- a separate column is required if the date of grant is different from the date of board or compensation committee action, showing the date such action was taken

The procedural details for which the SEC requires disclosure seem to derive directly from the problems that companies have detected during audits of their past grant-making records.

### SEC Office of the Chief Accountant

Accounting guidance related to the grants of stock options was provided by the SEC's Office of the Chief Accountant ("OCA") on September 19, 2006. The OCA guidance contained in its letter addressed to FEI and the AICPA is clearly limited to the impact of stock option granting practices on financial statements and the related footnotes, and does not address disclosure issues outside of the financial statements or the circumstances under which any stock option granting practices could violate laws or regulations. It targets issues relating to option granting practices prior to the time when FAS 123R was applicable. The OCA points out that in general, the accounting guidance applicable to many of the prior grants was, in most cases, Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (Opinion 25).

Opinion 25 generally applies to stock options before 2006, and provides special rules that hinge on the determination of a "measurement date." Opinion 25 defines this term as "the first date on which are known both:

- (1) the number of shares that an individual employee is entitled to receive, and
- (2) the option or purchase price, if any."

In general, under Opinion 25 compensation cost arose on the grant of an option to the extent the market price of the underlying stock at the measurement date exceeded the exercise price. Therefore, in order to determine compensation cost, a company must determine whether its stock option granting practices resulted in the grant of a stock option with an exercise price that was lower than the market price of the underlying stock on the date on which the terms and recipients of the stock options were determined with finality.

A company that determines its prior accounting contains material errors should restate its financial statements to reflect

the appropriate corrections. Disclosure of these issues should also include the circumstances that gave rise to the errors. The OCA appears to be open to the suggestion that material errors may be corrected without amending all previously filed periodic reports, by disclosing all the changes in one report. Companies who wish to address all errors in one report are urged to contact the staff of the Division of Corporation Finance.

The various issues interpreted by the OCA under Opinion 25 are briefly summarized below and may also be useful to companies in their determination of grant dates and measurement dates under FAS 123R.

### Dating an Option to Predate the Actual Award Date

Given that the measurement date is the first date on which both the number of options that an individual employee is entitled to receive and the exercise price are known, even if documents are dated as of an earlier date, the measurement date cannot occur until the date the terms and the recipient are determined.

### Option Grants with Administrative Delays

Two examples in which companies have accounted for option grants on a date other than the appropriate measurement date include (i) awarding options by obtaining verbal authorization from the board of directors or committee and subsequently completing the documents evidencing the award at a later date; and (ii) delegating authority to award options to a member of management without specific parameters, and obtaining any appropriate approvals thereafter.

If a company operates as if the terms of awards were not final prior to completion of all required granting actions (such as retracting awards or by changing their terms), the company should conclude that the measurement date for all of its awards, including those that were not changed, would be delayed until the completion of all required granting actions. However, if the facts and circumstances and pattern of conduct show that the terms and recipients of a stock option award were determined with finality on an earlier date, prior to the completion of all granting actions, it may be appropriate to conclude that the measurement date was the earlier date. The company's pattern of conduct must make clear that the terms and recipients were considered "fixed and unchangeable."

In evaluating whether a company's facts and circumstances support a conclusion that the measurement date was the earlier date, all information should be considered, including the pattern of historical stock option grants and the presence or absence of documentation of past stock option granting practices. A company may reach different conclusions with respect to these issues for different employee groups or award categories.

### Validity of Prior Grants

Issues have been raised with respect to past option grants as to whether an option can be accounted for as a fixed option with a measurement date on the date that the terms and recipient of the award were determined if uncertainty exists as to the validity of the grant. Specifically, the following questions have been raised:

- With respect to a shareholder-approved option plan that, for example, only permits at-the-money grants, is it possible that a measurement date did not occur at the date that the terms and recipient of the award were determined for in-the-money grants?
- Does the non-compliance of certain options with a company's option plan create uncertainty as to whether the company will ultimately have the ability to settle the award in stock or must it instead settle the award in cash?

In cases where (i) the company has been honoring the awards and settling in stock, (ii) the company intends to honor outstanding unexercised awards and has a reasonable basis to conclude that the most likely outcome is that the awards will be honored, and (iii) the company intends to settle the outstanding unexercised awards in stock and has a reasonable basis to conclude that it will be able to do so, then the substantive arrangement that is mutually understood by both the company and the employee represents the underlying economic substance of the past option grants. In that event, if all other conditions for the establishment of a measurement date have been satisfied, then it would be appropriate to account for the awards as fixed options with a measurement date on the date that the terms and recipient were fixed with finality. Further analysis of the facts and circumstances would be required in the situation where the company does not intend to or does not have a reasonable basis to conclude that it will be able to honor the award or settle it in stock.

### Uncertainty as to Individual Award Recipients

In instances where companies may have approved option awards before the number of options to be granted to each individual employee was finalized, no measurement date can occur until the number of shares that an individual employee is entitled to receive is known. If management's role was limited to ensuring that an allocation was made in accordance with definitive instructions (e.g. based on an individual's level within the organization) the measurement date could appropriately be the date the award was approved. If management had discretion on the allocation of awards, the measurement date could not be determined until the allocation to individual employees was finalized.

In addition, if changes to a list are made subsequent to the preparation of a list that was prepared on an award approval date, companies should conclude that either (i) the list prepared on the award approval date did not constitute a grant, in which case the measurement date for the entire award would be delayed until a final list has been determined or (ii) the list that was prepared constituted a grant and any subsequent changes should be evaluated to determine whether a modification or cancellation occurred, resulting in variable accounting.

### Exercise Price Set by Reference to a Future Market Price

With respect to an award that establishes an exercise price based on a formula, such as the lowest market price of the company's stock over a 30-day period beginning on the award approval date, the measurement date would occur on, and variable accounting would be required until, the date the contingency provision expires. Compensation cost related to the option would be the difference between the market price of the underlying stock at the end of the 30-day contingency period and the lowest market price of the stock during that period, which would be the exercise price. If the original terms of the award did not allow for an adjustment of the exercise price and the exercise price is in fact reduced after the award approval date upon the occurrence of a contingent event, the OCA believes that a repricing has occurred and variable accounting is appropriate from the date of modification to the date the award is exercised, forfeited or expires unexercised.

### Grants Prior to the Commencement of Employment

If a company determines the terms and conditions of a stock option for a new employee prior to commencement of employment, the appropriate accounting depends on whether the individual performed any services in the capacity of a non-employee prior to the commencement of employment. If no services were provided, a measurement date cannot be determined until the employment commencement date, and a compensation cost for a fixed stock option would be measured based on the difference between the exercise price of the option and the market price on the employment commencement date.

### Documentation of Option Granting Activities is Incomplete or Cannot be Located

In the course of reviewing option granting practices several years after the fact, some companies have been unable to locate definitive and complete documentation evidencing certain of the past option granting activities. Documents evidencing past grants may not exist, contemporaneous documentation of the date on which board or committee meeting was held may not have been prepared, written documents only include "as of" dates and not the dates the documents were actually prepared or the company may have reason to believe that the documents it has in its records are not accurate. Appropriate accounting depends on the facts and circumstances of a particular case. The

OCA does not believe that the lack of complete documentation several years after the fact should necessarily result in a default to variable accounting or to treating the awards as if they had never been granted. A company must instead use all available relevant information to form a reasonable conclusion as to the most likely option granting activities that occurred and the dates on which they occurred. For example, the existence of a pattern of past option grants with an exercise price equal to or near the lowest price of the entity's stock during the time period surrounding those grants could indicate that the terms were determined in hindsight. However, the OCA expressed no view as to the manner in which various forms of evidence and facts should be evaluated to determine whether historical accounting records are accurate.

### Timing of Option Grants

If a company selected award dates in coordination with the disclosure of material, non-public information (either before disclosure likely to result in an increase in the stock price, or delayed until after disclosure was expected to result in a decrease in the stock price), a compensation cost should be computed on the measurement date by reference to the unadjusted market price of a share of stock of the same class that trades freely in an established market.

### Changes to Option Grants

In some instances a company may have changed the terms of previously granted awards. That is, they may have reduced the exercise price after information subsequent to the award date was released which reduced the stock price. In that circumstance, there was a repricing and variable accounting should be applied from the date of modification to the date the award is exercised, forfeited or expires unexercised.

### Income Tax Benefits Related to Options

If an exercise is documented as though it occurred as of a date other than the actual date of exercise, which resulted in a reduction of the amount of income taxes due by the employee, with a corresponding reduction in the income tax benefit received by the company, then the company should record the excess tax benefit it otherwise would have been entitled to receive on the actual exercise date as an addition to paid-in capital. Any amount of such benefit foregone by the company due to the mischaracterized exercise and any other tax obligations of the employee paid by the company should be recorded as compensation cost to the employee.

The OCA acknowledged that the determination of grant date for income tax purposes may differ from the determination of measurement date pursuant to Opinion 25, and expressed no view as to the appropriate grant date of an option for income tax purposes.

## Recommendations

Those who want to avoid these problems – and avoid criticism for their processes for granting stock options – should consider the following best practices for option granting practices going forward:

- Assure the independence of the compensation committee, in part by redefining the role of management in the grant-making process;
- Implement a clear, written policy stating the grant-making process, including with respect to new hires, promotions and grants pursuant to delegated authority;
- Begin the process of determining who will receive grants and in what amounts well in advance of the committee or board meeting so that the numbers are fixed by the time of the meeting;
- Make stock option grants to executives and directors at the same time that grants are made to other employees;
- Make stock option grants at regular times, ideally during an open trading window period after the release of financial statements;
- Grant dates should be the same as the authorization and approval date; grants should not be subject to an earlier effective date unless it is consistent with applicable law and the terms and recipients are fixed and unchangeable as of that earlier date;
- Determine the exercise price by reference to the fair market value of the underlying shares as of the grant date (in order to avoid a required explanation and tabular disclosure in proxy statements);
- Properly document all award decisions, and properly execute all award agreements; establish trails documenting all granting decisions; and
- If award agreements cannot be properly executed relatively quickly, communicate the award to the applicable employee(s) so that the FAS 123R grant date is the same as the date board or committee action was taken. A sample email communication along the following lines will do the trick:

“At its meeting on \_\_\_\_ \_\_, 2006, our Compensation Committee approved a grant to you of stock options to

purchase \_\_\_ shares of our common stock, at a price equal to \$\_\_\_ per share (fair market value on the grant date). Your right to exercise these stock options will have a term of \_\_\_ years, will vest based on \_\_\_\_, and will be subject to the terms and conditions of our equity incentive plan (including those relating to early expiration in connection with termination of your employment) or other forfeiture circumstances that the committee establishes. Within the next few weeks, we will be incorporating these terms into a formal award agreement that you will have the opportunity to accept.”

### Notes

<sup>1</sup>*USA v. Reyes et al.*, 06-cr-005566-CRB, dated filed, 08/11/2006 (Brocade criminal case); *Securities and Exchange Commission v. Reyes et al.*, 06-cv-04435-CRB, date filed, 07/21/2006 (Brocade SEC civil case); *USA v. Alexander et al.*, 06-mj-00817-CLP, date filed, 07/31/2006 (Comverse criminal case); *Securities and Exchange Commission v. Alexander et al.*, 06-cv-03844-NGG-RER, date filed, 08/09/2006 (SEC civil case).

<sup>2</sup>For further information about the risks associated with back-dated or mis-dated stock options, see our Client Alert titled “Stock Option Issues Lead to SEC Investigation, Restatements and Litigation” dated June 2006 (copy available at [www.paulhastings.com](http://www.paulhastings.com)).

<sup>3</sup>SEC Release No. 34-54302. Our separate Client Alert focused on the rules generally is scheduled for release during September.

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**Please contact any member of our stock option grant steering committee listed below for further information about actions to consider – either to improve current practices or to properly address questions about past grants.**

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