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EQUITY GRANT PROCEDURES

During the past year, the Securities and Exchange Commission has conducted numerous investigations into stock option grant procedures, and guilty pleas have been received in several criminal cases where it was alleged that executives fraudulently backdated stock option grant dates in order to provide for lower, below-market exercise prices. A number of shareholder lawsuits have been filed against corporate directors and officers alleging securities law and fiduciary duty violations stemming from the backdating of options and other improprieties in connection with the granting of options. And because of the resulting accounting errors, the improper dating of options has forced a large number of companies to restate their historical financial statements.

The enforcement action announced by the SEC on May 14, 2008 against a co-founder and several other current and former top officers of Broadcom Corporation demonstrates that the SEC's interest in stock option backdating and other improprieties in grant procedures has not waned. As a result of the scrutiny equity grant practices are continuing to receive, all public companies that have not done so already should review the manner in which they grant equity awards to employees and directors.

What practices are being scrutinized?

There are primarily three: "backdating," "spring-loading" and "bullet dodging."

Backdating, which has probably received the most attention of the three (at least in the financial media), typically refers to the practice of choosing a grant date with the benefit of hindsight so that the date selected is earlier than the date on which the grant was actually approved, with the selected grant date usually being a date on which the market price is lower than the date on which the grant is actually approved. By backdating the option in this manner, the option instantly has intrinsic value to the optionee (because the exercise price is lower than the market price). In some cases, this is the result of deliberate, outright fraud, involving falsification of meeting minutes or written consent documents. In others, it's just poor plan administration involving inadvertent errors or missing paperwork (sometimes referred to as "misdating").

Spring-loading generally refers to the granting of equity awards in anticipation of the issuer's disclosure of material information that is likely to have a positive effect on the issuer's stock price (and consequently increase the intrinsic value of the award to the optionee). For example, knowing full well on May 1st that the issuer plans to publicly disclose material positive information on May 10th, rather than waiting until after May 10th to grant an option (at which time the market price of the issuer's stock, and consequently the exercise price of the option, would likely be higher), the issuer's compensation committee approves the option grant on May 1st, enabling the optionee to benefit from the lower exercise price. This practice may also involve a

deliberate delay in the release of positive material information until after the grant date.

Bullet dodging is the opposite of spring-loading – it refers to the practice of purposefully waiting until material negative information is publicly disclosed before granting an equity award. For example, knowing full well on June 10th that the issuer plans to publicly disclose material negative information on June 25th, the compensation committee deliberately waits until after June 25th to grant an option, enabling the optionee to benefit from the lower exercise price (because the market price of the issuer's stock has fallen following the release of the material negative news). This practice may also involve a release of material negative information ahead of schedule so that the stock price is likely to decline before the grant date.

Why are these practices problematic?

Most equity incentive plans provide that the exercise prices of stock options must equal or exceed the market value of the underlying stock on the date of grant. Accordingly, when shareholders are provided with proxy materials seeking their approval of the plan, the board is effectively representing to them that options will only be granted "at the market" or above. Backdating effectively results in the grant of below market options, since the exercise price is equal to the market value of the underlying stock on the earlier, "selected" grant date, when the market value was lower, rather than on the later, "real" grant date (i.e., the date on which the compensation committee or board actually approved the option), when the market value was higher.

Spring-loading and bullet dodging arguably also effectively result in below market options. In the case of spring-loading, the argument goes, the real market value of the underlying stock on the grant date is not the actual reported market price on that day, but the market price after the increase resulting from the release of material positive information. In the case of bullet dodging, the argument goes, the real grant date is not the date on which the grant actually occurred after the release of material negative information, but the earlier date, before the release of the material negative information, on which the committee or board knew it was going to grant the option. In a March 2008 decision, the Delaware Chancery Court declined to dismiss a breach of fiduciary duty claim brought against directors where it was alleged that the directors engaged in both spring loading and bullet dodging by granting stock options prior to quarterly earnings releases containing positive information and after releases containing negative information. This decision comes after a 2007 case in which the Delaware Chancery Court refused to dismiss a fiduciary duty claim alleging that directors granted spring-loaded options.

Although, under SFAS 123(R), most companies have been required to expense their options beginning with their first quarter 2006 financial statements, prior to that time, under APB 25, companies were not required to expense their options if they were granted "at the market." Consequently, as has been well-publicized in the financial press, where it has been discovered after the fact that pre-2006 option grants were effectively discounted options, financial restatements have been required as a result of the need to expense the options in prior year financial statements. Restatements of results for 2006 and later years could likewise be required if it is discovered after the fact that incorrect grant

dates were used for expensing options or other equity awards under SFAS 123(R).

Below market options can lead to a host of tax problems for the optionee and for the issuer. To the extent the option was intended to qualify as an incentive stock option (ISO), it will lose that favorable tax treatment, as one of the criteria for that treatment is that the exercise price be no lower than the market value of the underlying stock on the grant date. Below market options also do not qualify as performance-based compensation under Section 162(m) of the Internal Revenue Code; consequently, to the extent such options are granted to the CEO or any other "covered employee," the "spread" realized by the executive upon exercise will count toward the $1.0 million deductibility cap for the company. In addition, below market options are generally considered to be a form of deferred compensation under Section 409A of the Internal Revenue Code, potentially resulting in an excise tax becoming payable by the optionee.

What should my company do to minimize the risk of problems with equity grant practices?

You should review your existing practices in this area, consider adopting a formal written grant policy and tighten your internal controls, if needed.

How should my company go about adopting an equity award grant policy?

There is no "one size fits all" approach here. You should begin by clearly articulating the role that equity grants play in the company's compensation programs. Are they to be a regular component of the compensation provided to all employees or just employees at or above a certain level? What portion of management's long-term compensation should be in the form of equity grants, as opposed to other long-term incentives? To what extent should the various types of authorized equity awards be utilized (e.g., stock options, stock appreciation rights, restricted stock, restricted stock units, etc.)? The answers to these questions will drive the company's policies in this area, including the frequency of grants and the methods by which grants are determined and approved.

Key components of any equity grant policy include:

- **Frequency and Timing of Grants.** You should consider specifying in your policy that regular equity grants (e.g., annual grants) will only be made on fixed compensation committee or board meeting dates that are specified well in advance of the actual meeting date (e.g., state in the policy that the annual grants will be approved at the October meeting of the compensation committee, with the specific meeting date set at the beginning of the year). Some companies select these dates such that they will fall during "open windows" under their insider trading policies, so as to avoid allegations of spring-loading or bullet dodging. If you do so, the question becomes, do you postpone grants if, for whatever reason, you are forced to close the trading window before the scheduled grant date (e.g., a material potential acquisition being negotiated)? The problem with postponing the grants is that employees expecting to receive grants who are not privy to the material inside information will at the very least become suspicious that something is afoot, and will possibly become upset by the delays. Investors expecting to see Form 4s reporting grants to executive officers may also become suspicious. On the other hand, if your company does not

have regular grants, and equity awards instead are made at such times as are determined by the compensation committee or the board in its discretion, it may be prudent to provide in your policy that grants will only be made during open trading windows.

Your policy should provide that grants for new hires, promotions or otherwise on an ad hoc basis throughout the year must be made on set dates, such as the last business day of each month. See also the discussion below under "-Delegation."

- **Designate Equity Grants Compliance Persons.** The compensation committee should designate one or more employees to oversee the documentation, accounting and disclosure of all equity grants (including the execution of award agreements, the reporting of grant information to appropriate accounting personnel, delivery of the plan S-8 prospectus and timely filing of Form 4s).

- **Delegation.** If the compensation committee desires to delegate its authority to make equity grants (such as giving this authority to the CEO to make grants to new hires or for promotions), you must first determine whether the law of the company's state of incorporation allows for this delegation and also whether the delegation is permitted under the equity incentive plan document. The devil truly is in the details here. For example, under Delaware law, a compensation committee may delegate its option-granting authority to corporate officers, but not its authority to make stock grants. Any such delegation of authority should specify the aggregate and individual maximum numbers of shares that may be subject to specific types of awards during a specified time period (e.g., during each quarter), and the terms of awards. The person(s) to whom the authority has been delegated should be required to regularly report the details of grants to the compensation committee.

  In light of stock exchange listing requirements, the rules under Section 16 of the Securities Exchange Act of 1934 and Section 162(m) of the Internal Revenue Code, any such delegation should be limited to grants to non-executive employees. NASDAQ rules provide that compensation for Section 16 officers must be approved or recommended by the compensation committee. There is an exemption from the short-swing profit provisions of Section 16(b) of the Securities Exchange Act of 1934 for equity grants that have been approved by either the full board of directors or a committee of two or more "non-employee directors." In order for stock options to qualify as "performance-based compensation" under Section 162(m) of the Internal Revenue Code, the grants must be approved by a committee comprised solely of "outside directors."

- **Grants at Meetings.** To the extent practicable, grants by the compensation committee should be made at a meeting of the committee held in person or telephonically and not by unanimous written consent. Under most state laws, unanimous written consents are not effective until the last signature is received (even if an earlier effective date is provided for in the consent). This can give the appearance of grant date manipulation. If a unanimous written consent must be used in lieu of a meeting, it should be dated the date(s)

on which the directors actually sign the document, not "as of" a particular date.

- **Form of Equity Award Agreements.** Equity grants are considered to have been made for accounting purposes on the date the grant is approved as long as the terms of the award are communicated to the grantee within a relatively short period of time following that date. Therefore, the compensation committee should approve the forms of award agreements at or before the meeting at which grants are approved. If different forms of agreements are to be utilized depending on what class of employees the grantee falls under (e.g., senior management vs. rank and file), the compensation committee should approve all forms of agreement in advance and controls should be in place to ensure that the grantee receives the correct form of agreement.

How are equity grant procedures dealt with under the SEC's compensation disclosure rules?

In its list of 15 examples of possible material information to be addressed in the CD&A section (which is not required for companies with a public float below $75 million, referred to as "smaller reporting companies), the SEC suggested that there be an explanation of how the determination is made as to when equity awards are granted. The SEC has said that if a company has a practice of timing equity grants in coordination with the public release of material information, disclosure should be made in CD&A section regarding this practice - basically, how and why it was done. The SEC has made clear that these disclosure considerations/requirements apply to all forms of equity compensation (not just options). Disclosure also is required to be added to the "Grants of Plan-Based Awards" table (also not required for smaller reporting companies) if (a) the date on which the compensation committee or board approved an equity award differs from the grant date of the award or (b) the exercise price of a stock option differs from the closing price of the underlying stock on the grant date. With respect to the latter, you should check the terms of your equity incentive plan(s) to see if the market value for purposes of determining the exercise price of a stock option is anything other than the closing stock price on the grant date (e.g., the closing price on the business day immediately preceding the grant date).

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