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SEC STAFF PERMITS VOTE ON SHAREHOLDER PROPOSAL REQUIRING APPROVAL OF STOCK OPTION REPRICING

In a significant reversal of position, the staff of the Securities and Exchange Commission ("SEC") has effectively required a company to include, as a proxy voting item at its forthcoming annual shareholders' meeting, a proposal from an institutional investor that would mandate prior shareholder approval of stock option repricings.[1] The proposal, if approved by shareholders, would amend the company's by-laws to require the consent of shareholders for any future stock option repricings.

While this event may have occurred too late to trigger similar proposals to be included in the 1999 proxy materials for companies having a fiscal calendar year, companies which have repriced options in recent years and will hold annual meetings in June or later can expect similar proposals from one or more institutional shareholders. Coupled with the Financial Accounting Standard Board's ("FASB") tentative decision to apply variable compensation expense to repriced stock options[2] and mounting criticisms from institutions, the media and commentators, this should result in a decline in the number of future option repricings. It also raises the possibility of even more aggressive shareholder proposals that would encumber a board's ability to unilaterally make compensation decisions.

Background

For years, the SEC staff had agreed with companies that compensation policy and practices were strictly matters conducted by the board of directors in the course of "ordinary business operations." Under a long-standing SEC proxy solicitation rule, matters that are deemed part of a

1 General DataComm Industries, Inc. December 9, 1998.

2 See our alert letter of 12/1/98.

company's ordinary business operations can *not* be the subject of a proposal submitted by a shareholder.[3] With regard to executive and employee compensation, this began to change in the early 1990s when the SEC staff permitted a shareholder proposal to be placed on the proxy in the form of a recommendation that the board prohibit future payments resulting from a change-in-control.[4] In making this change the SEC staff noted that, in its view, the public debate concerning "parachute" payments had reached a sufficient level and raised significant policy issues to overcome the ordinary business argument.

Subsequently, the SEC staff has permitted numerous compensation-related proposals from shareholders to be included on the proxy for a forthcoming annual meeting. Recent examples included proposals in the form of requests to the board of directors to:

- Index the compensation of the ten most highly paid executives to the company's share price performance;[5]

- Commission an independent study to evaluate the criteria and procedures for setting executive compensation;[6] and

- Implement a policy requiring shareholder approval for any executive severance payment exceeding $3,000,000.[7]

Each of these proposals was in the form of a recommendation to the board. This format reflected the SEC staff's aversion to permitting proposals that mandate policy actions by the board, since any such proposal would preclude the board's ability to exercise business judgement and would effectively usurp its fiduciary role. By using this precatory approach, the board is put on notice of a shareholder preference if the proposal is passed. But the board is not obligated to carry out the desired action. However, a proposal to change the by-laws, such as the option repricing proposal, does mandate a specific action. Therefore, it is not surprising that, while the shareholder requests cited above were being required to be placed on the respective proxies, the SEC staff also was permitting companies to *omit* a proposed by-laws change that would require shareholder approval of any stock option repricings.[8]

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3 See Rule 14a-8(i)(7) under SEC Regulation 14A. This Rule sets forth the criteria and ground rules that must be adhered to for a shareholder proposal to be acceptable for inclusion in a company's proxy solicitation materials. The Rule also sets forth the specific circumstances in which a company may omit a proposal, provided the company makes a timely filing with the SEC setting forth its arguments why such omission is proper. If the SEC staff agrees with the company's rationale, the shareholder proposal can be omitted.

4 See our alert letter of February 1, 1990.

5 Allegheny Energy Inc. March 5, 1998 (See also Knight Ridder March 5, 1998).

6 Crown Central Petroleum Corp. March 10, 1998 (See also Unocal Corporation, March 24, 1998).

7 Time Warner, Inc. February 2, 1998.

8 Shiva Corp. March 10, 1998.

The Proposal

As indicated above, the repricing prohibition proposal, which the SEC staff has required the company to include in its proxy materials, is not in the form of a suggestion to or request of the board of directors. Rather, if passed, it would mandate a change in the company's by-laws. Specifically, the by-laws would state:

> "Option Repricing -- The company shall not reprice any stock options already issued and outstanding to a lower strike price at any time during the term of such option, without the prior approval of shareholders."

Note that this language would appear to permit the surrender of existing higher-priced stock options in exchange for new, lower-priced options. Clearly, this was not the intent of the State of Wisconsin Investment Board ("SWIB") which submitted this proposal. Presumably, they intended that the scope of this by-laws provision would mirror that of the SEC's executive compensation disclosure rules, i.e., "repricing" includes "cancellation or replacement grants, or any other means" of effectively repricing underwater stock options.[9]

Possible Responses and Implications

Given the SEC staff's change in position, it is quite conceivable that SWIB and other shareholders will submit similar by-laws repricing proposals, not only to companies which have had one or more repricings in the past, but also to ones where repricings have not occurred. However, for those companies that have included in a plan approved by shareholders a provision similar to the by-laws language above, the issue should be moot.[10] For those companies with plans that overtly include the possibility of repricings (or are silent on the issue), the board could amend the plan to add a repricing prohibition which should also suffice to make the proposal moot. For a company that believed it might have a need for some future repricings to retain key skilled personnel, a plan provision that limited aggregate repricings to a maximum of ten percent of plan shares, for example, and specifically excluded the repricing of stock options held by executive officers, might also work to prevent inclusion of a by-law amendment in the company's future proxy materials.

An issue the SEC may face is where does it draw the line on permitting shareholders to effect compensation policy through a by-laws amendment or similar strategy? Two examples of possible similar shareholder proposals are a by-laws amendment requiring either: (1) shareholder approval of any compensation that would not be deductible for federal income tax purposes; or (2) that any company stock issued to employees in a compensatory manner be issued only under plans and arrangements approved by stockholders. The former would clearly infringe on the

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[9] FASB has tentatively embraced a similar broad definition that includes any cancellation followed by a regrant within six months.

[10] See Rule 14a-8(i)(10) which permits omission of a shareholder proposal if the proposal "has already been substantially implemented" by the company.

board of directors' traditional role, since tax deductibility requires meeting terms and standards -- because of Internal Revenue Code Section 162(m) -- that the board could truthfully believe go counter to how the company should be managed on a day-to-day basis. The latter would, of course, deny boards the latitude most now have to grant options and other stock-based awards under non-shareholder approved plans (at least for companies incorporated in states where shareholder approval is not required). In summary, the fallout from this change in SEC position will be interesting to follow.

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The purpose of this document is to alert compensation professionals and other interested persons of an important development that may affect a public company's unilateral ability to set compensation policy in the future. General questions can be addressed to Larry Bickford at (212) 986-6330 or LCBICKFORD@FWCOOK.COM. Specific questions relating to a company's actual situation should be taken to qualified legal counsel. This document and the others issued by us which are cited in footnotes are available at the above Web site address.