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Institute Issues Statement to the NYSE Corporate Accountability and Listing Standards Committee, May 2002

Statement of the Investment Company Institute to the NYSE Corporate Accountability and Listing Standards Committee

May 17, 2002

The Investment Company Institute[1] appreciates the opportunity to provide its views on corporate governance and shareholder accountability issues. These issues are of significant interest to our members, as investors in equity securities worth more than 3.5 trillion dollars on behalf of millions of middle-income Americans.

The Institute commends the Exchange for appointing this special Committee to review corporate governance matters and listing requirements, and develop recommendations designed to bolster shareholder confidence. These matters are especially important in the wake of the Enron scandal. We would like to focus our comments on one issue in particular—the role of shareholders in the authorization of stock option plans. We believe that stricter standards in this area are needed in order to ensure that the interests of shareholders are protected in compensation matters.

The Institute previously has recommended that the Exchange amend its listing standards to require shareholder approval of certain stock option plans.[2] The Institute recognizes that stock option plans can be beneficial by aligning shareholder and corporate management interests and in furthering corporate stability. Indeed, if properly designed, such plans can enable a company to attract and retain key personnel, and provide incentives for employees to work hard to increase a company's value, thereby increasing the potential for maximizing shareholder return. On the other hand, stock option plans that are improperly designed can cause the interests of management and shareholders to conflict and, consequently, have a deleterious effect on shareholder value.

Many stock option plans have the potential of transferring wealth or voting power from shareholders to corporate management. Plans that are not tied to company or stock performance can have a dilutive effect on existing shareholders. Some stock option plans, for example, provide for the issuance of shares at no cost or at a significant discount to the then-current fair market value. Other plans permit the repricing of so-called "underwater" options to current market value without prior shareholder approval. Still other plans, such as "evergreen" or reload option plans, have similar dilutive effects on shareholders' equity.[3]

The increasing popularity of stock option plans and the potentially dilutive effect they can have on shareholder value highlights the need to ensure that they receive appropriate shareholder scrutiny. This is particularly compelling given the unavoidable conflict of interest faced by management as they design such plans. Denying shareholders the right to review, evaluate and vote on these plans allows corporate management to act in a manner that is patently inconsistent with shareholders' best interests.

For the reasons discussed above, the Institute urges the Exchange to require shareholder approval for stock option plans. There are different approaches that the Exchange could take to implement our recommendation. One approach would be to require that shareholders have an opportunity to vote on all plans (and plan amendments). This approach has some merit, as it would be the most comprehensive way to protect shareholder value. Another approach would be to limit the requirement to those instances where the plan is most likely to have a significant adverse effect upon shareholders' interests. If the Exchange were to take this approach, we would recommend that, at a minimum, shareholder approval be required in two cases: first, in any situation where the plan would grant options to officers and directors; and second, in any situation where the options granted would exceed a specified dilution threshold. Under the latter, it is important that the threshold be applied on a cumulative basis so that an issuer could not avoid a shareholder approval requirement by granting options on an annual basis in an amount under the threshold (but where the cumulative effect would be over the threshold). In addition, the requirement for shareholder approval should also apply to the repricing of outstanding options (including the cancellation of options and issuance of new options at lower exercise prices six

months and one day later). Otherwise, the requirement could be circumvented by issuers unilaterally changing the exercise prices of options after issuing them.

Ideally, any changes to the Exchange's listing standards to require shareholder approval of stock option plans should be done in coordination with Nasdaq. Harmonization of these requirements would ensure that the leading securities markets do not compete on the basis of disparities in their rules, leading to a "race to the bottom" to attract new listings, to the ultimate detriment of investors. Nevertheless, in view of the increasingly high levels of dilution embedded in corporate stock option plans, we urge the Exchange to proceed on its own to address this problem rather than wait to act in tandem with Nasdaq.

We appreciate your consideration of our views.

ENDNOTES

[1]The Investment Company Institute is the national association of the American investment company industry. Its membership includes 9,064 open-end investment companies ("mutual funds"), 485 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $7.050 trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders.

[2] See L e tt er from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated December 10, 1998; letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Stephen Walsh, Vice President and Managing Director, New York Stock Exchange, Inc., dated July 9, 1998.

[3] Evergreen option plans, in which a nominal percentage of shares outstanding (e.g., one percent) are reserved for award each year, can be dilutive because (a) there is no termination date for the plan and (b) the number of shares issued potentially can increase yearly depending on the number of shares outstanding. Reload options, which are options that are used to replace shares of stock that executives use to exercise current options, can be dilutive depending on the date that is used for determining the market value of the option. In many cases, the date used for valuing a reloaded option is not the date on which the current option is exercised (i.e., the then-current market price), but rather the date on which the current option was originally granted—often years earlier.

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