

Comment Letter on NYSE, Nasdaq Stock Option Approval Proposals, November 2002

November 1, 2002

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Notice of Filing of Proposed Rule Changes by the New York Stock Exchange (File No. SR-NYSE-2002-46) and the National Association of Securities Dealers, Inc. (File No. SR-NASD-2002-140) Relating to Shareholder Approval of Stock Option Plans

Dear Mr. Katz:

The Investment Company Institute¹ appreciates the opportunity to comment on the New York Stock Exchange and Nasdaq proposals to require shareholder approval of equity-compensation, or stock option, plans.² As investors in U.S. equity securities worth approximately \$2 trillion on behalf of millions of middle-income Americans, the Institute's members have a significant interest in this issue. We strongly support both the NYSE and Nasdaq proposals to require shareholder approval of stock option plans and any material revisions of those plans. Shareholder review of stock option plans will assist in assuring that corporate management's decisions regarding stock option plans are aligned with their shareholders' best interests. We do, however, recommend certain modifications to the proposals. Specifically, we recommend that the NYSE modify its approach with respect to "evergreen" plans and that Nasdaq explicitly follow the NYSE's approach with respect to repricing of options. These comments are discussed in more detail below.

I. General Comments

The Institute has consistently advocated shareholder approval of stock option plans.³ We believe 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, many stock option plans have a potentially harmful effect on shareholder value through the transfer of wealth and voting power from shareholders to corporate management. Some stock option plans, for example, provide for the issuance of shares at no cost or at a significant discount from 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" plans, can have similar dilutive effects on shareholder value.

The increasing popularity of stock option plans and the potentially dilutive effect that they can have on shareholder value underscore the need to ensure that these plans receive appropriate shareholder scrutiny. This is critical given the conflict faced by corporate management as they formulate such plans. Requiring that shareholders be given the opportunity to express their view on whether a particular stock option plan should be implemented will help to assure that corporate management's decisions regarding these plans are aligned with their shareholders' best interests. Therefore, the Institute strongly supports these proposals.

We also are pleased that the NYSE and Nasdaq proposals are very similar with respect to requiring shareholders to approve stock option plans. Such a coordinated approach ensures that the NYSE and Nasdaq do not compete on the basis of differences in their rules, encouraging a "race to the bottom" to attract new listings, to the ultimate detriment of investors.

II. Specific Comments

A. Repricing of Options

The NYSE Release states that if a plan contains a provision that prohibits repricing of options, any revision that deletes or limits the scope of such a provision will be considered a material revision for purposes of this rule, thereby triggering the requirement for shareholder approval. The NYSE Release further states that if a plan does not contain a provision that specifically permits repricing of options, the plan will be considered for this purpose as prohibiting repricing, and any actual repricing of options will be considered a material revision of the plan, even if the plan itself is not revised. The Nasdaq Release does not specifically address repricing of options. We support the NYSE's views with respect to repricing options and urge Nasdaq to make explicit in any adopting release that it is taking the same approach as the NYSE.

B. Evergreen Plans

Evergreen plans, in which a nominal percentage of shares outstanding are reserved for award each year, can be dilutive because there could be no termination date for the plan and the number of shares issued can increase annually depending on the number of shares outstanding. Under the NYSE proposal, an automatic increase in the shares available under a plan pursuant to a formula set forth in the plan will not be considered a revision if the term of the plan is limited to no more than ten years. It is our understanding that most evergreen plans already are limited to a term of ten years. Therefore, the practical effect of the NYSE's proposal is to permit existing evergreen plans to increase the shares available for ten years without obtaining shareholder approval for the increased shares. Because the Nasdaq Release does not specifically address evergreen plans, it is unclear whether Nasdaq would view an automatic increase in the shares available under a plan pursuant to such a formula to be a revision in the plan that must be submitted for shareholder approval. We urge the NYSE and Nasdaq to view an automatic increase in the shares available under an evergreen plan to be a material revision in the plan that must be submitted for shareholder approval.

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We appreciate the Commission's consideration of our comments on these important proposals and look forward to commenting on other aspects of the NYSE's and Nasdaq's corporate governance proposals when they are published for comment. If you have any questions or need additional information, please contact me at (202) 218-3563.

Sincerely,

Dorothy M. Donohue
Associate Counsel

cc: Annette L. Nazareth
Director
Division of Market Regulation

Mr. James L. Cochrane
Senior Vice President
New York Stock Exchange

Ms. Sara Bloom
Associate General Counsel
The Nasdaq Stock Market, Inc.

ENDNOTES

¹ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,982 open-end investment companies ("mutual funds"), 513 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.373 trillion, accounting for approximately 95 percent of total industry assets, and over 90.2 million individual shareholders.

² Securities Exchange Act Release No. 46620 (October 8, 2002) [67 FR 63486 (October 11, 2002)] ("NYSE Release"); Securities Exchange Act Release No. 46649 (October 11, 2002) [67 FR 64173 (October 17, 2002)] ("Nasdaq Release").

³ The Institute recently expressed its strong support for the NYSE requiring shareholder approval of equity-compensation plans. See [Letter](#) from Craig S. Tyle, General Counsel, Investment Company Institute, to Mr. James L. Cochrane, Senior Vice President, New York Stock Exchange, Inc., dated July 19, 2002; [Statement](#) of Investment Company Institute to the NYSE Corporate Accountability and Listing Standards Committee (Matthew P. Fink, President) (May 17, 2002). In addition to recent expressions of support for this

initiative, the Institute previously recommended that the NYSE amend its listing standards to require shareholder approval of certain stock option plans. See [Letter](#) 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. The Institute previously expressed similar support for Nasdaq requiring shareholder approval of stock option plans, especially those with the potential to dilute shareholder value. See [Letter](#) from Kathy D. Ireland, Associate Counsel, Investment Company Institute, to Mr. Robert Aber, Senior Vice President, The Nasdaq Stock Market, Inc., dated February 5, 2001.

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