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COUNCIL OF INSTITUTIONAL INVESTORS

June 21, 2006

Nancy M. Morris
Secretary,
Securities and Exchange Commission
100 F Street, NE,
Washington, DC 20549-9303



RE: File Number S7-03-06
Executive Compensation and Related Party Disclosure

Dear Ms. Morris:

I am writing on behalf of the Council of Institutional Investors, an association of more than 140 corporate, union, and public pension plans with more than \$3 trillion in assets. The Council requests that the Commission accept this letter as additional comment in response to the Commission's proposed Executive Compensation and Related Party Disclosure rule.

Recent reports regarding stock-option granting practices at some companies have raised significant concern for investors. Concerns center on two major topics: 1) the potential that some stock option grants have been backdated; and 2) the potential that companies may be purposely timing equity grants to take advantage of significant events or news releases that are likely to affect the market value of their stock. We believe the Commission should consider potential amendments to the proposed disclosure rule as well as other disclosures and actions in response to these issues.

The Council recognizes that backdating and grant-timing may not in all circumstances be illegal. However, we strongly believe these practices are inconsistent with the long-term interests of shareowners and obviously can have very significant potential legal ramifications. In each case, we believe these practices are akin to insider trading and very specific disclosures should be required to assist investors in monitoring the behavior of companies in this regard.

Accordingly, we request the Commission consider the following actions:

- 1) Amend the Executive Compensation and Related Party Disclosure rule proposal to provide the following:
 - a) A requirement that companies disclose whether they have adopted a comprehensive policy regarding equity grants. The required disclosure should include specific components of the policy, including grant-date timing, methodologies for establishing strike prices, the roles of responsible parties related to key steps in establishing and administering equity grants, and the basic procedures the company will use to ensure the equity grants are administered in compliance with the policy. The Council believes this policy should address all equity grants to any employees, not just Section 16 officers, but any differences in the treatment of varying classes of employees should be clearly delineated.

- b) The date(s) in the preceding year in which the committee approved each equity grant, and the date the grant became effective. Any discrepancy between these dates should be fully explained. The Council continues to support the Commission's proposed disclosure of the grant date for stock or option awards in the Supplemental Annual Compensation Tables.
 - c) For each equity grant, a requirement that companies provide a brief explanation for the purpose of the award and the grant date of the award. We believe the Commission should require adequate disclosure such that investors will be able to clearly identify situations in which equity grants are made, even if only partially, for the purpose of timing specific events or news, whether specific to the company or otherwise.
- 2) Review current requirements and enforcement of disclosures related to equity grants made to Section 16 officers. The Council believes the provisions in the Sarbanes-Oxley Act that strengthened the reporting requirements under Section 16(a) of the Exchange Act have likely been an impediment to backdating practices since their implementation in August 2002. Under the new rules, reporting changes in beneficial ownership through a Form 4 filing, including receipt of a grant of stock options, must be done within two business days of receipt of the grant.

However, it appears that in some instances the Form 4 filings are not being made in a timely manner. According to a recent study,¹ roughly one fifth of a sample of approximately 3,700 option grants between August 2002 and November 2004 violated the two-business-day reporting requirement. Moreover, the study indicated that those grants that were not reported in time were associated with return patterns suggestive of backdating, and the magnitude of the return pattern was greater the longer the delay in reporting. Thus, it appears that, if the two-day reporting requirement is not complied with, the beneficial impact of the requirement as it relates to inhibiting backdating is diminished.

The Council requests the Commission consider the following actions related to Form 4:

- a) Increased enforcement action and penalties for non-compliance with the current two-business-day filing requirement for Form 4.
- b) For each instance in which the filing requirement for Form 4 is violated, require disclosure in the company's proxy statement of the reason for the violation and the status of any action resulting from the violation.

In addition to improved disclosure related to equity granting policies and procedures noted above, the Council believes SEC enforcement action is a critical element of an appropriate response to the backdating scandal. The Council strongly supports the SEC's regulatory actions to date. We believe it is imperative that the Commission investigate fully all instances where there is evidence of backdating and take strong action against all participating parties, including board directors and legal counsel, in those circumstances where improper behavior is discovered. In cases where it is determined fraudulent or misrepresentative disclosures and financial statements occurred, we believe it is appropriate for the

¹ Does backdating explain the stock price pattern around executive stock option grants? Randall A. Heron, Kelley School of Business, Indiana University, and Erik Lie, Henry B. Tippie College of Business, University of Iowa. Paper is forthcoming in the Journal of Financial Economics. JEL classification: J33; M52 Keywords: Executive stock option grants; Backdating.

Commission to seek to nullify the related grants or seek restitution of the gains associated with the grants.

Finally, the Council believes that the backdating controversy illustrates that the financial accounting and reporting for employee stock option grants is an area in which there is a high risk of intentional misapplication of the accounting requirements. The Council notes that those companies involved in the backdating controversy appear to have failed to comply with the rules-based exception contained in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("Opinion 25").

The Opinion 25 exception permitted companies for over 30 years to structure their option grants to understate compensation cost and inflate reporting earnings. Financial Accounting Standards Board Statement No. 123R, *Share-Based Payments* ("FAS 123R"), which became effective for most companies on January 1, 2006, replaced the Opinion 25 rules-based exception with a principles-based standard.

FAS 123R improves financial accounting and reporting of stock option grants by requiring that, consistent with the Council's corporate governance policies, all employee stock option grants be accounted for as compensation costs reducing reported earnings. The Council, however, is concerned that some preliminary evidence surrounding the adoption of Statement 123R appears to indicate that some companies may be intentionally understating certain inputs required by the standard in an effort to continue the Opinion 25 practice of understating compensation costs and inflating reported earnings.² The Council believes that the benefits of Statement 123R will not be fully realized by investors unless and until the SEC closely monitors and rigorously enforces a high quality implementation of the standard's requirements.

The Council looks forward to continuing to work with the Commission to improve the quality of information investors receive about executive compensation.

Sincerely,



Ann Yerger
Executive Director

CC: The Honorable Richard C. Shelby, Chairman, Committee on Banking, Housing, and Urban Affairs
The Honorable Paul S. Sarbanes, Ranking Member, Committee on Banking, Housing, and Urban Affairs
The Honorable Michael G. Oxley, Chairman, Committee on Financial Services
The Honorable Barney Frank, Ranking Member, Committee on Financial Services

² Jack T. Ciesielski, *The Accounting Analyst's Observer* (May 2, 2006), page 16 (indicating that 81% of companies examined had reduced their volatility input for measuring the cost of employee stock options in 2005).