INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

July 9, 1998

Comment Letter on NYSE Shareholder Approval Policy Regarding Stock Option Plans, August 1998

July 9, 1998

Mr. Stephen Walsh
Vice President and Managing Director
New York Stock Exchange, Inc.
20 Broad Street, 16th Floor
New York, New York 10005

Re: NYSE Shareholder Approval Policy
(File No. SR-NYSE-97-37)

Dear Mr. Walsh:

The Investment Company Institute[1] appreciates the opportunity to express its views on the New York Stock Exchange’s ("NYSE" or "Exchange") amendments to its shareholder approval policy (the "policy"), the policy that dictates when stock option plans should be subject to shareholder approval.[2] Investment companies and private account clients of investment advisers are significant purchasers of listed companies’ shares and, as such, have an interest in this matter. We believe that it is important that the public be given an appropriate opportunity to comment on the recent changes to the policy, particularly the 20 percent test under the definition of "broadly based plan." Although, like others, we regret that the process by which the rule changes were made did not result in any input from interested parties, we are nonetheless pleased that the Exchange decided to open the revised rule for comment and will establish a task force to consider possible changes to the policy.

Investment advisers, on behalf of their investment company and private account clients, review and cast their votes on thousands of proxy proposals every year, many of which pertain to the creation or amendment of stock option plans. Stock option plans can be beneficial in aligning shareholder and corporate management interests and in furthering corporate stability. Indeed, if designed appropriately, such plans can enable a company to attract and retain key personnel and provide added incentives for employee investment in the corporation’s underlying securities, thereby increasing the potential for maximizing shareholder return. If designed inappropriately, however, stock option plans can have a deleterious effect on shareholder value.

The Institute notes that shares issued under stock option plans represent an ever-increasing amount of shares outstanding for many U.S. companies. Many of these plans, however, have the significant potential of transferring wealth or voting power from shareholders to corporate management. We are concerned that such plans can have a dilutive effect on shareholders' equity—or may not be based directly on performance or tied to pre-established performance goals. 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 (e.g., discounted or restricted stock). Other plans permit the repricing of so-called "underwater" options to current market value without prior shareholder approval.[3] Still other plans have similar dilutive effects on shareholders' equity.[4]

Because of the many, varied permutations available in designing stock option plans, and the potentially dilutive effect such plans and plan amendments can have on shareholder value, we believe that it has become increasingly important for shareholders to be given the opportunity to review, evaluate, and vote on all stock option plans proposed, or proposed to be amended, by management. We believe that the real issue is not how a stock option plan is characterized (i.e., broadly based or non-broadly based), but rather, how the plan would affect a company's existing shareholders. Any plan that, either by itself or in the aggregate with other existing plans, would have a significant dilutive effect on existing shareholders should require shareholder approval. Thus, we believe that the Exchange should only exempt a stock option plan from shareholder approval if that plan, either by itself or in the aggregate with other existing plans, is not likely to lead to a significant transfer of wealth or voting power from shareholders to corporate management. Thus, we recommend that the Exchange consider revising the policy to reflect this concern.

In the event, however, that the Exchange decides to continue its policy of exempting "broadly based plans" from the shareholder approval requirement, we would suggest various modifications to it that would make the policy more effective in protecting shareholders' interests.

First, in contrast to the guidance recently issued, the Institute believes that the definition of "broadly-based plan" should be based on actual plan participation by company employees, rather than mere eligibility. Inherent in this position is the belief that any test of "broadly based" would be meaningless without taking into account the mix of employees that may participate (i.e., non-management employees versus officers and directors). Indeed, just because non-management employees are eligible to participate in a company's stock option plan does not mean necessarily that they will in fact participate in the plan.[5] In this way, only those plans that actually benefit a broad number of non-management employees would be exempt from the shareholder approval requirement. To the extent companies decide to establish for the first time a stock option plan, because of the concerns noted above, we recommend that any such plan first be submitted to shareholders for their approval as well.

Second, the Institute is not convinced that the 20 percent threshold in the NYSE's safe harbor is an appropriate benchmark, particularly given the ease with which a company could circumvent the shareholder approval requirement by simply rolling its non-broadly based plan into an ostensibly broadly based plan and adding just enough non-management employees to satisfy the test.[6] As stated, we believe that for a plan to be truly "broadly based," participation by a greater amount of a company's non-management employee workforce should be required.[7] This would help protect shareholders' interests by requiring shareholder approval of those plans that could significantly dilute shareholder interest and voting power. Moreover, as part of this recommendation, we also recommend that the definition of "broadly based plan" be exclusive rather than a non-exclusive safe harbor, as currently drafted. Because the definition of "broadly based plan" will have important ramifications, we believe that each component of the definition should be satisfied in order for a plan to qualify for exemption from the shareholder approval requirement. This would further protect against companies’ circumventing the requirement.

Finally, to address concerns about potential dilution, we also recommend that a threshold for cumulative dilution be imposed for broadly based plans. Imposing a threshold would impose safeguards to further protect shareholders’ interests in those instances where broadly based plans are not subject to shareholder approval. Thus, this would ensure that any plan which, taken together with all other plans currently in effect, would exceed a prescribed threshold of cumulative dilution, should be subject to shareholder approval.[8]

* * *

The Institute appreciates the opportunity to comment on the NYSE’s rule amendments to its shareholder approval policy regarding broadly based stock option plans. If you have any questions concerning our comments or would like additional information, please contact me at (202) 326-5824 or Barry E. Simmons at (202) 326-5923.

Sincerely,

Amy B.R. Lancellotta
Senior Counsel

cc: Catherine R. Kinney,
Group Executive Vice President
Richard A. Grasso,
Chairman and Chief Executive Officer
New York Stock Exchange, Inc.

Richard R. Lindsey
Director, Division of Market Regulation
U.S. Securities and Exchange Commission

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,091 open-end investment companies ("mutual funds"), 437 closed-end investment companies, and 9 sponsors of unit investment trusts. Its mutual fund members have assets of about $4.989 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 499 associate members which render investment management services exclusively to non-investment company clients. A substantial portion of the total assets managed by registered investment advisers are managed by these Institute members and associate members.

2 NYSE, Inc., Stockholder Approval Requirements for Broadly-Based Stock Option Plans, dated June 5, 1998, Request for Comment ("Request for Comment"). Among other things, Paragraph 312.04(g) of the Exchange’s Listed Companies Manual was amended to provide guidance for determining whether a plan is "broadly based." As part of this guidance, the

Exchange adopted a "safe harbor" to provide that a plan will be deemed to be "broadly based" if at least 20 percent of the company's employees are eligible to receive stock or options under the plan and at least half of those eligible are neither officers nor directors (the "20 percent test").

3 An "underwater" option is an option whose issue price exceeds the underlying securities' current market price, thereby rendering the option worthless. Underwater options can be particularly dilutive in situations where management cancels an option plan but decides to make the unissued shares related to the canceled option available for future reissuances.

4 Reload options, for example, 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. Thus, reload options not only can have a dilutive effect on shareholders' equity by allowing the additional issuance of shares, but in a rising market, can provide the option holder with built-in appreciation. Moreover, "evergreen" option plans, in which a nominal percentage of shares outstanding (e.g., one percent) are reserved for the plan, similarly can be dilutive because (i) there is no termination date for the plan, (ii) the number of shares issued potentially can increase yearly depending on the number of shares outstanding, and (iii) any amendments to the plan are not subject to shareholder approval.

5 Generally, the decision on who actually gets to participate, which commonly is made by a compensation committee (whose members also may receive discretionary options), often is heavily weighed in favor of corporate management and directors— frequently to the exclusion of all other employees.

6 For example, a company with one hundred employees in its workforce need only have eleven non-executive employees (and nine officers or directors) included in its stock option program in order to avoid the shareholder approval requirement. Certainly, a plan that includes only ten percent of a company's non-management, employee workforce could hardly be viewed as "broadly based."

7 The Request For Comment makes reference to the 70 percent participation requirement imposed by the Internal Revenue Code and asks whether a higher threshold with certain employees excluded should be provided. We would support a higher threshold (e.g., 50 percent or more) to the extent that it promotes our fundamental concern that any broadly based plan should have an appropriate mix of non-management employees and officers and not be used as a means to transfer wealth and voting power from shareholders to management.

8 Consistent with the approach taken by the Exchange for key employee plans, we would recommend a similar threshold level of dilution (e.g., five percent), recognizing that for some companies (e.g., start-up companies, etc.) a different threshold level may be required.

should not be considered a substitute for, legal advice.