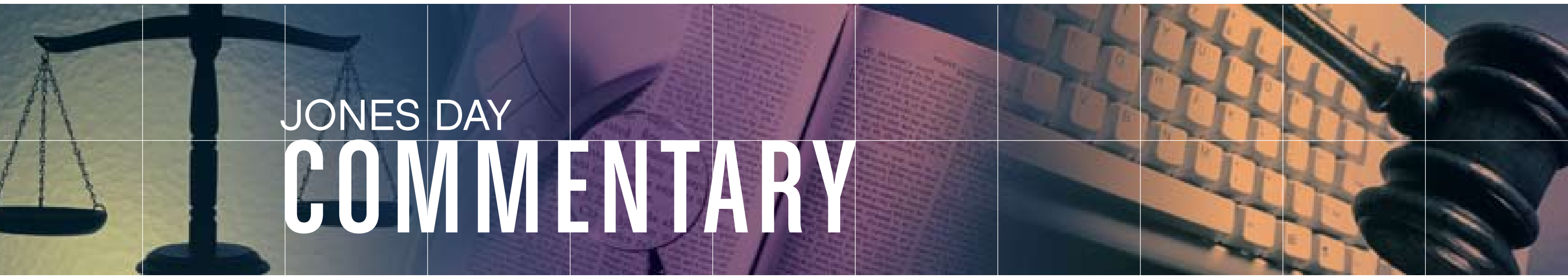
JULY 2006



STOCK OPTION TIMING: THE SCRUTINY INTENSIFIES

With the filing of civil and criminal complaints last week against executives of Brocade Communications Systems, Inc., and the SEC's adoption of new executive compensation disclosure rules on July 26, 2006 (which will require companies to disclose information about their option grant practices), the SEC and the Department of Justice have made it clear that the federal government is committed to exposing and eliminating fraud and criminal misconduct associated with the timing of stock option grants. In light of the charges filed against the Brocade executives and the other widely reported SEC and Department of Justice investigations into the stock option grant practices at a number of other public companies, this *Commentary* reviews the scope of the investigations and their potential ramifications and recommends steps to be considered going forward. Although many of the alleged abuses under investigation took place prior to the Sarbanes-Oxley requirement that option grants be reported within two business days after grant and prior to the implementation of FAS No. 123R, *Share-Based Payment* (requiring companies to expense the grant-date fair value of *all* stock options rather than just those granted below fair market value), we believe the procedures outlined in this *Commentary* continue to provide relevant guidance to public companies today.

The option-granting practices called into question by the regulators can be grouped into three general categories:

- "Backdating," or using an option grant date earlier than the date on which the options were actually granted.
- Failure to follow proper board procedures by misdating, changing, or altering the recorded date of a board or compensation committee resolution, board or compensation committee meeting, grant notification, or option agreement.
- "Spring-loading," or granting stock options shortly before the public release of favorable information, and "bullet-dodging," or waiting for unfavorable information to depress the market price before making a grant.

In view of the recent indictments, the intense media scrutiny of this issue, the inquiries now being routinely made by third parties, and the likelihood of auditor inquiries as part of 10-Q reviews and annual audits, we recommend that our clients educate themselves about the issues arising from the option grant investigations and review their past and current option grant practices. If a review reveals questionable options practices, the company board should consider what action to take, which in some instances may include director-supervised investigations. However, the potential consequences of such actions should be carefully considered.

POTENTIAL RAMIFICATIONS

Options backdating in and of itself is generally not illegal under U.S. law, but the failure to disclose or account for backdated options properly can have significant implications. However, prior to reviewing the litany of potential legal issues, we think it is important to draw a line (similar to that drawn in GAAP between "errors" and "irregularities") between circumstances involving serious legal/governance issues and technical noncompliance issues that many, if not most, companies will confront when reviewing their historical option grant practices. From our perspective, the key question (and distinguishing characteristic) between technical errors and more serious issues is whether the board of directors or the compensation committee knowingly approved the terms of stock option grants and the prices at which the options were exercisable. While technical issues may exist that could require changes in option-granting procedures going forward, absent evidence of fraud or manipulation, these technical issues should not, in many instances, be treated as a legal or governance crisis mandating special committee investigations, up-the-ladder reporting and disclosure, or similar extraordinary actions.

With these baseline considerations in mind, a list of possible implications of option-granting errors or irregularities follows.

SEC, Department of Justice, and IRS Investigations/Proceedings. One of the most immediate issues facing many companies is the possibility of civil and criminal investigations initiated by the SEC, the Department of Justice, and/or the Internal Revenue Service. More than 80 companies are currently the subject of one or more investigations. Some state attorneys general have also begun investigations concerning option-granting practices. Regulators and criminal prosecutors have a wide array of civil and criminal actions they can pursue and various remedies they can seek for option grant abuses, including criminal indictments, civil injunctions and administrative cease-and-desist orders, disgorgement, financial penalties, and bars precluding service as an officer or director of a public company.

As noted above, on July 20, 2006, the United States Attorney's Office for the Northern District of California, the SEC, and the FBI announced the filing of civil and/or criminal securities fraud charges against former executives of Brocade Communications Systems, Inc., a company that had been under investigation prior to the current spate of inquiries. The charges allege that the company routinely backdated stock option grants without recording necessary compensation expenses as required by GAAP. If found guilty, the executives face up to 20 years in prison with respect to the criminal charges and a $5 million fine with respect to the civil charges. In connection with announcing the charges, SEC chairman Christopher Cox stated that "options backdating strikes at the heart of investor confidence in our capital markets [and] . . . deceives investors and the market as a whole about the financial health of companies that cheat in this way." Chairman Cox suggested that additional charges may be brought against other companies under investigation as the SEC "is committed to bringing [options backdating] to an end nationwide."

Restatements. An immediate risk facing some companies under investigation is the potential restatement of historical financial statements resulting from the failure to record compensation expense with any backdated options. Under the long-standing APB 25 accounting standards (which have been superseded by FAS 123R), compensation expense for option grants needed to be recorded only if the exercise price was less than the fair market value of the underlying stock at the date of the option grant – so-called discount options. Therefore, if an option was backdated, a company may have improperly failed to record compensation expense, which may require it to restate historical financial statements. A number of companies under investigation have already announced that they will be restating historical financial statements. Accounting errors of this type may also give rise to a finding of a material weakness in a company's internal controls, as well as possible forfeitures of option profits under Section 304 of Sarbanes-Oxley. At least one company has already disclosed a "significant deficiency" in its internal controls as a result of its backdating practices. As noted below, the failure to record income tax expense properly can also trigger a restatement.

Tax Implications. Stock options granted at a discount, whether due to backdating or otherwise, may result in tax issues. Discount options are not exempt from the $1 million cap on certain executive pay. Therefore, all or part of the spread when the option is exercised may not be deductible, depending on the circumstances. Discount options will also fail to be exempt from the newly enacted, highly punitive legislation governing so-called nonqualified deferred compensation. In some cases, the options may be grandfathered from the new rules or may be eligible for special transition relief before January 1, 2007. Otherwise, the options must be substantially amended prior to January 1, 2007, in order to comply with the new law, or significant tax penalties could be imposed on the optionees. Finally, discount options cannot qualify for the favorable tax treatment provided for incentive stock options. The foregoing tax consequences could be affected by applicable statutes of limitations, may include additional reporting and withholding obligations, and may affect the financial accounting for taxes related to the options.

Theories for Potential Civil and Criminal Liability. Because improper accounting and disclosure regarding a company's option grant practices can have a material impact on the accuracy of its financial statements, claims under multiple federal and state statutory provisions, as well as common law, are likely if disclosure of improper practices becomes required. If an investigation reveals material errors related to option grants, liability may arise under the financial reporting, books and records, and internal control provisions of the Securities Exchange Act of 1934 (Exchange Act Sections 13(a) and 13(b) and the SEC rules promulgated thereunder). Such misconduct could also expose a company and the officers and directors involved to further violations of the anti-fraud provisions of the Securities Act of 1933 and the Exchange Act (Securities Act Section 17(a), Exchange Act Section 10(b), and Rule 10b-5). Criminal proceedings for violations of the conspiracy and mail and wire fraud statutes are also possible. Improper disclosures or accounting for options could render statements in a company's proxy materials false or misleading. Inaccurate reporting in an individual officer's or director's Form 3 or 4 filings, reflecting personal securities transactions, could also give rise to potential liability under Exchange Act Section 16 and related SEC rules. In addition, federal tax liability provisions may be implicated. At the state level, multiple derivative lawsuits have followed recent disclosures about improper accounting for options, alleging that the officers and directors involved breached their fiduciary duties to the corporation under state corporate law.

Inquiries From Institutional Shareholders and Others. Several major institutional investors and shareholder groups, including CalPERS, the AFL-CIO, and the Counsel of Institutional Investors, have sent letters to over 1,000 public companies requesting additional information regarding stock option grant procedures. These letters have included requests to disclose whether the companies' executive pay practices are under investigation or whether any option grants were improperly timed, and they also suggested that the companies adopt new safeguards. Consistent with its aggressive approach to executive compensation generally, the AFL-CIO's January 13, 2006 letter requested compensation committees to: (1) grant options on predetermined dates that are at least 30 days from earning announcements, (2) set grant dates independently from executives, (3) avoid granting options for executives and directors at the same time, and (4) consider replacing options with stock grants that vest after performance goals are met. The AFL-CIO also requested the SEC to address stock option grants as part of its proposed overhaul of the executive compensation disclosure rules. In a June 7, 2006 letter to a number of companies, CalPERS urged directors to: (1) conduct independent investigations into backdating allegations, (2) publicly disclose all findings from both internal and external investigations, (3) develop and disclose publicly a new board policy for the determination of option grant dates, (4) refrain from using company resources to satisfy any tax or legal liabilities of executives implicated for wrongdoing relating to backdating of options, and (5) commit to having approval of external auditors ratified by shareholders on an annual basis. CII's June 12, 2006 letter requested recipient companies to disclose their policies for setting the timing of option grants, including whether the board permits executives to have a role in the choosing of the grant date. Responses will be posted on CII's web page (www.cii.org).

Auditor Reviews. As a result of the investigations and media scrutiny, independent accounting firms have been requiring companies to represent affirmatively that they do not have any backdated options during the years covered by audit reports and to provide documentary evidence going back for substantial periods. As a result, many companies reviewed or are reviewing their option grant practices, which has caused some of them to delay the filing of their annual and quarterly reports with the SEC.

SEC Filing Delays; Possible Delisting. Companies that are unable to file timely Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q are required to file a Rule 12b-25 notification. Similarly, companies that are required to restate historical financial statements may be required to file a Current Report on Form 8-K under Item 4.02 as to nonreliance on historical financial statements. As a result of the potential restatements and the related inability of many companies to file Quarterly Reports on Form 10-Q and Annual Reports on Form 10-K in a timely manner, many companies under investigation have been notified by NASDAQ or the NYSE that they may be delisted if timely compliance with SEC reporting requirements cannot be achieved.

SEC Reporting/Disclosure Issues. Many companies under investigation have filed a Current Report on Form 8-K disclosing the investigation(s) and any resulting events, such as a derivative shareholder lawsuit. If a company faces a potential delisting, a Current Report on Form 8-K must also be filed. Additionally, on July 26, 2006, the SEC voted to adopt changes to the rules requiring disclosure of executive and director compensation, related-person transactions, director independence and other corporate governance matters, and security ownership of officers and directors. These new rules will require companies to explain their option grant practices and, in particular, whether option grants are specifically timed to the public release of company information and the circumstances involving grants where the exercise price does not match the market value of the stock on the date of grant.

Corporate Governance Issues. Backdating, misdating, and other associated irregularities governing stock option grant practices may give rise to a finding of deficiencies in a company's corporate governance functions, as well as in its internal controls and audit functions. These irregularities can in turn give rise to claims that directors failed in their oversight responsibility. Deficient option grant procedures, to the extent they constitute material noncompliance with the option plan, can also lead to invalidation of option grants or Securities Act registration requirements and violations of stock exchange rules and regulations. Finally, and perhaps most importantly, issues in this area may fracture board-management relationships that in some companies are already under stress since Sarbanes-Oxley was enacted.

RECOMMENDED STOCK OPTION GRANT PRACTICES

In view of these potential ramifications, we recommend that companies be particularly mindful as they administer stock option plans. In particular, companies should consider adopting very specific procedures in this area. Some of these procedures are summarized below. However, this should be treated as recommended "best practices" and not necessarily required by law.

Regular Grant Cycle. Option grants should normally be made in accordance with a regular grant cycle, which provides for option grants to be made in the same general time frame from year to year. Exceptions would be made for new hires, for which individualized option grants would be necessary. Companies ought to batch authorization of new-hire option grants with regularly scheduled grants to avoid the appearance of special treatment. Vesting credit can be given from the date of hire if not inconsistent with the plan.

Grants Following Release of Material Information. As a legal matter, "spring-loading" (when options are granted in advance of the release of positive news) is not illegal so long as the board of directors or committee granting the options has access to the material facts at the time of approval of the grant. Nonetheless, in today's highly charged corporate governance environment, particularly in circumstances in which the company is in possession of undisclosed positive news, companies should consider whether to grant stock options only after all material information has been publicly disseminated. This consideration would have the effect that option grant dates (*i.e.,* dates of meetings of the board of directors or its compensation committees at which options are granted or effective dates for written consents) would not be set during a period preceding an event that is likely to affect the company's stock price. Granting options during normal trading windows might be considered.

Record Keeping. Grant agreements should comply with the terms of the company's stock option plans, which in almost all instances require that options be granted at no less than "fair market value" on the "date of grant." In addition, the resolutions authorizing the grant should explicitly set the option exercise price exactly as provided for in the relevant stock option plan (*e.g.,* a trading price or the closing price immediately preceding or on the date of grant). The same pricing formula should be used consistently for all related purposes.

No Changes to Specified List of Optionees. Additional optionees or grants should not be added at a later date to the board or compensation committee schedule listing the names of optionees and the number of shares subject to the grant. Otherwise, the additional grant could be deemed to have been made at a price less than fair market value.

Eliminate or Closely Monitor Officer or Single Director Grants. Section 157 of the Delaware General Corporation Law permits a board of directors to delegate authority to an officer or officers to select option recipients and the number of options granted if certain parameters are established. We suggest that companies specifically evaluate the extent, if any, to which option-granting authority should be delegated by the compensation committee or board. In our view, companies generally should not delegate authority to the companies' most senior executives, but should delegate option-granting authority (within director-approved parameters) for lower-level employees.

Use of Unanimous Consents. Authorizing grants of options at board or committee meetings – rather than by written consents – may make it easier to establish that the grants were made on an informed and deliberate basis and, consequently, to satisfy the enhanced disclosure requirements contemplated by the SEC's new disclosure rules. In any event, companies should be aware that, under state law, actions taken by a board or committee by unanimous consent may not be deemed effective until the last director has signed the consent and other procedural requirements (such as filing the consent with the minutes of the proceedings of the board or committee) have been satisfied. Thus, the potential timing implications associated with the use of written consents to authorize option grants should be considered carefully.

Notification of Grant. Companies should promptly communicate option grants to the optionee. Failure to do so may give rise to tax consequences and affect accounting treatment, which assumes that prompt notice will be given to grant recipients. Companies may consequently find that a delayed notification date will be treated as the grant date.

Review of Internal Controls. Compensation committees should exercise general oversight in this area (as required by most equity plans). Public companies should review and test their procedures and controls to confirm they are effective. As noted above, companies that have not yet reviewed their option grant practices may face a request from their auditors requiring such a review as part of the Quarterly Report on Form 10-Q and/or Annual Report on Form 10-K certification process.

Review Other Equity-Based Compensation Awards. Although the media focus to date has been on stock option plans because of the accounting and tax implications, similar issues may arise for restricted stock, restricted stock units, or other equity-based forms of compensation where the timing or value of the grant is tied to the value of the award.

We are not suggesting a "one size fits all" approach for every company, but we do think that in the current environment, companies should review their option grant programs with these considerations in mind. If your company decides to initiate an internal review concerning its options practices, is contacted by federal or state regulators or law enforcement agencies about your company's option program, or receives a letter of inquiry or subpoena, please let us know and we will put you in touch with a member of the task force we have established at Jones Day that is highly experienced in this area.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our “Contact Us” form, which can be found at www.jonesday.com.

Corporate Governance and Disclosure

Robert T. Clarkson
1.650.739.3996
rtclarkson@jonesday.com

Lyle G. Ganske
1.216.586.7264
lgganske@jonesday.com

Christopher M. Kelly
1.212.326.3438
ckelly@jonesday.com

Elizabeth Clough Kitslaar
1.312.269.4114
ekitslaar@jonesday.com

David P. Porter
1.216.586.7215
dporter@jonesday.com

Robert A. Profusek
1.212.326.3800
raprofusek@jonesday.com

Lizanne Thomas
1.404.581.8411
lthomas@jonesday.com

Tax/Executive Compensation

Dennis B. Drapkin
1.214.969.4850
dbdrapkin@jonesday.com

Louis Rorimer
1.216.586.7224
lrorimer@jonesday.com

Securities and Shareholder Litigation/ Corporate Criminal Investigations

Charles M. Carberry
1.212.326.3920
carberry@jonesday.com

David L. Carden
1.212.326.3839
dlcarden@jonesday.com

John D. Cline
1.415.875.5812
jcline@jonesday.com

Harold K. Gordon
1.212.326.3740
hkgordon@jonesday.com

John M. Newman, Jr.
1.216.586.7207
jmnewman@jonesday.com

Peter J. Romatowski
1.202.879.7625
pjromatowski@jonesday.com

Jayant W. Tambe
1.212.326.3604
jtambe@jonesday.com

Patricia J. Villareal
1.214.969.2973
pjvillareal@jonesday.com