Consumer Federation of America

February 5, 2001

Mr. Robert Aber
Senior Vice President
The Nasdaq Stock Market, Inc.
1801 K Street, 8th Floor
Washington, DC 20006

RE: Request for Comments on Stock Option Proposals

Dear Mr. Aber:

I am writing on behalf of the Consumer Federation of America[1] to urge the Nasdaq Stock Market to update and strengthen its requirements for shareholder approval of stock option plans. CFA appreciates this opportunity to comment on what we view as an important issue of corporate governance.

We do not approach this issue out of any antagonism toward use of option-based incentive plans. On the contrary, we believe the use of stock-based compensation programs has been an important tool allowing many companies, particularly smaller companies in the early stages of their development, to attract and retain talented employees despite their inability to pay the lucrative salaries that more established corporations offer. Furthermore, as Nasdaq has noted in its request for comments, when appropriately structured, such programs can help to align employee and shareholder interests in promoting long-term shareholder value.

Nonetheless, stock option plans also have the potential to create conflicts between the interests of shareholders and the interests of company management and employees. One widely acknowledged conflict is the potential for self-dealing that exists when directors and top executives participate in the plans. Another is the potential for material dilution of shareholders' equity that exists when the shares outstanding and shares available for grant under the program reach a certain critical mass.

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[1] The Consumer Federation of America is a non-profit association of approximately 280 pro-consumer organizations created in 1968 to advance the consumer interest through advocacy and education.

The first conflict is already reflected, if imperfectly, in the existing requirement for shareholder review of plans in which officers and directors constitute a majority of participants and receive the majority of the benefits. However, for more broadly based plans, the requirement for shareholder approval is lifted. The idea behind the exemption is that "the potential for self-dealing is mitigated in these circumstances." In fact, however, the conflict is not mitigated. It simply carries a higher pricetag, one that shareholders will be forced to pay through a dilution of their holdings.

For this reason, CFA shares the view of Securities and Exchange Commission Chairman Arthur Levitt, that good corporate governance policy demands that all plans in which officers and directors participate be subject to shareholder approval. We also share Chairman Levitt's view that shareholders should have an opportunity to vote on any plan with the potential to materially dilute shareholder equity. Knowing that options plans will be subject to shareholder approval should create a strong incentive for companies to structure those plans in ways that benefit both employees and shareholders.

We are concerned that the Nasdaq request for comment seems designed to produce alternatives to the approach outlined by the NYSE task force. CFA feels strongly that the NYSE task force recommendations should also serve as the basis for any Nasdaq revisions to its rules. Those recommendations were worked out after in-depth study and extensive negotiations by knowledgeable representatives from both the investor and corporate communities. They strike a good balance between providing shareholders with enhanced oversight of stock-based compensation plans and providing corporations with needed flexibility to operate such plans. While it may be appropriate to make some minor alterations to strengthen that proposal, we would strongly discourage Nasdaq from heading off in a radically different direction. The unfortunate, but all too likely result would be regulatory arbitrage, in which markets compete for listings by lowering their requirements.

CFA believes many of the concerns that seem to underlie the search for alternatives are unwarranted. First, there seems to be an assumption that requiring shareholder approval of stock option plans would put barriers in the way of corporations seeking to offer stock option compensation. Evidence suggests, however, that many if not most companies that currently use stock-based compensation plans already seek shareholder approval. And, when such proposals are put before shareholders, they are almost always approved. In fact, to the degree that shareholder activists have weighed in on the issue of stock-based compensation, it has not been to oppose such plans, but rather to encourage the adoption of truly broad-based plans that reach all, or virtually all, employees. Furthermore, the task force recommendations provide corporations with a great deal of flexibility in responding to specific circumstances with the use of non-approved shares.

The request for comments also seems to be seeking some concrete measure of when acceptable dilution becomes unacceptable, presumably as the basis for a standard that would define when a shareholder vote is necessary. This seems to us to be a misguided approach, since each circumstance must be judged on its own merits, and each investor may judge the case differently. In short, these are issues that may appropriately determine how shareholders evaluate a particular stock options plan, but they should not be used to determine whether investors have the opportunity to evaluate that plan.

Finally, Nasdaq seems to suggest that the fiduciary duty and oversight of independent board members may substitute for shareholder approval. We strongly disagree. The fact is that standards for independent board representation and oversight vary greatly from company to company. And, the very companies that may be among those most likely to rely heavily on stock-based compensation plans -- Internet companies, for example -- may also be among the least likely to have strong independent oversight on the board.[2] However, even if high standards for independent board oversight were universally adopted, this would not eliminate the need to provide shareholders with an opportunity to vote on stock options plans for which they will foot the bill. And, as we have noted above, ensuring that such plans will be subject to public scrutiny offers that best assurance that they will be structured in appropriate ways.

To sum up, given the rapidly growing use of stock option compensation plans and the potential for those plans to be structured in ways that undermine shareholder value, CFA believes it is appropriate for the major markets to adopt new, strengthened requirements for shareholder approval of stock option plans. We believe the NYSE task force recommendations offer an appropriate basis for those standards, since they achieve a good balance between the increased oversight sought by shareholders and the flexibility sought by the corporate community. We further believe that investors will be best served if the exchanges work together, with the Securities and Exchange Commission, to adopt uniform standards in this area. We urge Nasdaq to move forward as quickly as possible in adopting enhanced stock options review standards.

Respectfully submitted,

Barbara L. N. Roper
Director of Investor Protection

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[2] A study by the Investor Responsibility Research Center released in January 2000 found that, on average, just 53 percent of the directors serving on the boards of 39 dot-com companies surveyed are considered independent, compared to 67.6 percent for boards of S&P 500 companies. Even more striking, only six percent of the surveyed companies had established committees to monitor corporate government issues, compared with more than 50 percent of S&P 500 companies.