STOCK OPTION PLANS AS EMPLOYEE INCENTIVES: WHAT CAN ARMENIA LEARN FROM U.S. EXPERIENCES?

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ABSTRACT

Throughout the era after the World War II stock options have been used by companies as an employee incentive and as an essential part of executive compensation. For corporations, stock options are attractive tools because they may be varied to find the most attractive form of incentives without any extra expenses.

This paper presents the history of the first regulations of stock options in the United States, the use of stock options before, during and after the Great Depression and the main issues occurred during the use of this device. The main purpose of this thesis is to present the experience of the United States, especially the abuses and the regulatory responses. Because the United States has the longest history with the use of stock options as an employee and executive incentives, countries like Armenia – where options are still not used as such incentives – could learn a lot from the American experiences, what this paper is aimed to show. This thesis also presents the new US regulatory framework (more specifically the Dodd-Frank Act) as the most recent model aimed at preventing abuses with executive compensations including stock options. This study also examines the possible use of stock options in the Republic of Armenia, outlines the pertaining legal issues and provides possible solutions.

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ABBREVIATIONS

DFA	Dodd–Frank Wall Street Reform and Consumer Protection Act
DOJ	United States Department of Justice
EPS	Earnings Per Share
ESOP	Employee Stock Option Plans
GAAP	Generally Accepted Accounting Principles
ISO	Incentive Stock Options
ISS	Institutional Shareholder Services
SEC	U.S. Securities and Exchange Commission
S&P 500	Standard & Poor's 500

INTRODUCTION

It is more than 100 years that stock options are significant elements in the executive compensation program at major U.S. corporations. The traditional practice is to grant compensatory stock options only to limited groups of managers and executives, that is why in some cases the device calls executives' stock option. However, during the years, the use of this incentive device becomes wider and the companies started to grant stock options to a broader group of employees. This proofs the National Compensation Survey publish in March 2010 by the “Federal Bureau of Labor Statistics” which states that 8% of all private industry workers have an access to the stock options from which the 15% of employees from the companies with 500 or more workers, 22% from insurance and finance, 16% from utilities and 36% from information business.[1]

For busting the use of employee stock options U.S. regulators granted tax benefits for certain employee stock options (qualified stock options). These benefits had a significant impact on the increase of the use of stock options, however, some commentators believe that it is preferable to use stock options which do not have any tax benefit (non-qualified stock options).[2]

In spite the fact that stock options were and still remain one of the most used equity compensation mechanisms, there were and still there are several issues regarding the use of stock options. More specifically the use of these devices sometimes is being criticized for abuses that executives do. Option backdating and stock buybacks were and remain the main types of abuses

[1] Financial benefits: Access, private industry workers, National Compensation Survey, March 2010, http://www.bls.gov/ncs/ebs/benefits/2010/ownership/private/table25a.pdf.
[2] Herbert Kraus, Executive Stock Options and Stock Appreciation Rights 3-4, (Lslf edition 2015).

which are connected with the use of stock options. The commentators in most cases are connecting the U.S. financial crisis also with stock options. In addition to this after Great Recession, the Dodd-Frank Act was adopted for regulating the financial and banking industry. This act contains also provisions for executive compensation, including stock options. The main idea of these provisions is to prevent and avoid from the possible abuses, however, some abuses such as stock buybacks are a steady issue for many U.S. corporations.

The information in the pages and the chapters that follow are designed to demonstrate the core of the employee stock options, the experience of the U.S. of using this device and the valuable lessons for countries not having an experience of the use of this device such as Armenia.

The First Chapter will briefly introduce derivatives and more specifically options. It will present the history and diverse use of options. This chapter will also present the stock options and their use as executive compensation and employee incentives. In addition to this in this chapter, it will be analyzed some certain legal issues connected with stock options such as the doctrine of consideration.

The Second Chapter, which is the core of this thesis, will introduce the first regulations of stock options, starting from the Internal Revenue Code of 1950, when the statute first defined restricted stock options.[3] This chapter will present the main types of abuses, buybacks, and backdatings, connected with the use of employee stock options. It will also deeply analyze and explain the legal issues regarding these abuses with empiric and hypothetical examples. This chapter will also present the regulatory framework presented by U.S. senate after the Great

[3] The incentive stock options had been called restricted stock options between 1950 and 1964. Under the Economic Recovery Tax Act of 1981 they become incentive stock options

Recession when the mentioned abuses were being considered as one of the main reasons of the financial crisis.

The Third Chapter will present current legal situation in the Republic of Armenia regarding the use of stock options. It will analyze the main legal issues and will present possible solutions to the mentioned issues. This chapter will also examine the possible use of stock options in the Republic of Armenia.

CHAPTER 1. STOCK OPTIONS

1.1 Stock options basics

For lawyers and economists, the definition of derivatives is different. This is connected with their approaches to that certain device. For lawyers, a derivative is a contract giving rights and obligation regarding an underlying asset which can be anything.[4] However, for economist derivatives are financial instruments. The values of these instruments are derived or based on other variables or assets.[5] The most used types of these financial devices are options, forward, future and swap.

In 4th-century BC Greek philosopher Aristotle in his book “Politics” mentioned about option contracts. This is the description of first known option contract. In his book, Aristotle tells the story about another philosopher, Thales of Miletus, who developed a financial device, which helped him to get profit from an olive harvest. Thales was a poor philosopher and he wanted to show that he is smart and he can also become rich. By using his knowledge about stars, he predicted that the olive crop for the upcoming season will be very good. He used his limited resources to reserve the olive presses for the upcoming season. In the autumn when it became clear that there is a great olive harvest Tales was the monopolist of the olive presses. At that time, he could change the use of the presses with whatever he wanted.

[4] Derivatives; The Key principals; Castagnino, John-Peter. Oxford : Oxford University Press, 2009; page 1

[5] International finance: transactions, policy, and regulation; New York. : Foundation Press, 2009, page 921

"Essentially, an option grants the holder the right to purchase or sell a particular item at a specific price for a specific period of time. For example, a common type of option on stock entitles the holder to buy a specified number of shares of stock from a second party (the option "writer") at an agreed upon price (the "exercise" or "striking" price)."[6] There should be a specific period of time when the option right can exist. During that time, the holder is entitled to get the shares from the option issuer with an agreed exercise price.

There are two types of options, call option and put option. "A Call option gives the holder the right to to buy (to call) from the writer the specified underlying at the specified exercise price. A put option gives the holder the right to sell (to put) to the writer the specified underlying at the specified exercise price."[7]

In the first half of 20th century, the US companies started to use options for creating a new device which would help them to not only motivate the professional management but also to save cash. This new device called stock options.

A Stock option is a contract which gives the holder a right to buy or sell the underlying share until the expiration date of the option during a specific time and at a specific price ("exercise price"). "Put option" gives the holder the right to sell the underlying share while the "call option" gives the right the holder to buy the underlying security. In case if before expiration date the holder does not exercise the option the holder cannot exercise the option anymore and the option expires. The exercise price which is specified in option contract calls "strike price". It is worth to mention that for employee stock option plans the is not commonly used.

Options are derivatives because its values are based on or derive from an underlying

[6] *Id.*
[7] Castagnino, *Supra* note 5.

security (stock on which the option contract is based). The security traded under stock option contract are the number of stocks which are represented by the certain option.

The current stock price of underlying security is usually the same exercise price of the option. For option holders, the main way of getting profits from the stock options is to exercise the call option when the market price of the stock of the underlying security is higher than the exercise price of the option. In this mentioned case the option can be considered as "above water" or "in the money" because the holder of the option has the right to buy the underlying stock cheaper than he has to pay for buying the stock itself.

Stock options are being used by investors for different purposes such as for hedging against the price decline, for speculation and for locking in a future purchase price of a stock. Stock options are also being used as a tactical device during mergers and acquisitions. The stock options can be used as a "poison pill" to discourage the hostile takeovers and can be "lock-up" which will give the favorable bidder opportunity to acquire the company.

"Poison pills" which are also known as "shareholders rights plan" or "share purchase rights plans"[8] is a security issued by the target company to make itself less attractive in the eyes of the hostile acquirer. The corporate laws of several states allow the stock option issuers to add some provisions which will not let the option holder to exercise the option fully or transfer it to another person and the option holders can only exercise the specified percentage of the option. In that case, the stock options are being granted to the existing shareholders, which can be a cause for a dilution of the interest of the unwelcome acquirer. In some states of US, such as New York, North Carolina, Ohio, Pennsylvania, South Carolina and Tennessee the provisions are designed

[8] William J. Carney, Mergers and Acquisitions Cases and Materials, 263, Robert C. Clark, 2000.

mostly for public companies however corporations laws of some states, such as Ohia and Tennessee also allow the private companies to use this weapon via stock options.[9] It is worth mentioning that in compensatory stock options usually does not contain "poison pill" provisions.

In the case when the corporation is a target for hostile acquirer (unwanted bidder) the target company may seek the aid of "white knight" which is another company and more acceptable for the target company. The "white knight" makes more favorable offers for the target company such as the higher price for the stocks of the company. In some cases, management may also look for a "white knight" which will promise not to disassemble the target company or will not lay off management or other employees.[10] A lock-up is an arrangement by which the target company gives a competitive advantage to the "white knight".[11] "Lock-up" usually involves granting the "white knight" a stock option. These types of "lock-ups" called "stock lock-ups". The "stock lock-up" is an option agreement which gives the holder, in this case, "white knight" right to buy treasury shares or authorized but unissued shares of the target company.[12]

1.2 Compensatory Stock Options

The overcome of analysis of federal income tax law shows that there are two categories of compensatory stock options: Non-qualified stock options and qualified stock options

[9] Ohio Rev. Code Ann. § 1701.16(B)(1)(f) and (B)(2); Tenn. Code Ann. § 48-16-205(b)(1)(F) and (B)(2).
[10] Patrick A. Gaugham, Mergers, Acquisitions, and Corporate Restructurings, 222, 2015.
[11] *Lock-Up Options: Towards a State Law Standard*, 96, Harv. L. Rev. 1068, (Mar. 1983).
[12] *Id.*

(incentive stock options (ISOs)).[13] ISOs are options granted by corporations to individuals for reasons regarding his or her employment. This option should be granted by employer corporation, or its subsidiary or parent to buy stock of any of the mentioned corporations.[14] In addition to this such options are ISOs if-

a) Such option is granted according to a plan, including combined number of stocks which may be issued under that certain option and the employees (or some of them) qualified to receive such options. During 12 months before or after this plan adopted, it should be approved by the shareholders of the corporation which grants the option;[15]
b) The option is granted during 10 years from the day when the plan is approved by shareholders or when the plan is adopted, whichever is earlier;[16]
c) According to the terms of the option, the option is not exercisable after the expiration of defined 10 years from the grating date;[17]
d) The price of such option is not less the fair market value of the stock of the option granting time;[18]
e) The option cannot be transferred to another person otherwise than by distribution, laws of descent, or will and can be exercised only by the holder, during his lifetime;[19]
f) At the option granting time, the holder of such an option does not own stock possessing stocks more than 10% of the total aggregated voting power of all stocks issued by the employer corporation or by the subsidiaries or parent companies.[20]

[13] I.R.C. § 422 (1986).
[14] I.R.C. § 422 (b) (1986).
[15] I.R.C. § 422 (b) (1) (1986).
[16] I.R.C. § 422 (b) (2) (1986).
[17] I.R.C. § 422 (b) (3) (1986).
[18] I.R.C. § 422 (b) (4) (1986).
[19] I.R.C. § 422 (b) (5) (1986).

The ISOs are being considered as qualified stock options because they are qualified for certain tax benefits. The options can obtain these tax benefits from Internal Revenue Code (IRC). The compensatory stock options other than ISOs are non-qualified stock options. The holders of this type of options cannot obtain the tax benefits defined in IRC for ISOs. The names of qualified and non-qualified stock options started to be in use during 1964 and 1976 when the IRC identified tax-benefited stock options as qualified.[21] The incentive stock options had been called restricted stock options between 1950 and 1964, however, under the Economic Recovery Tax Act of 1981, they become incentive stock options.[22]

Stock options are widely used by corporations as employee compensation which has different purposes. The main purposes of using stock options as employee compensation are the retention of cash, which for many companies are an important issue, the motivation of employees and the reward of the key employees for their contributions to the companies. For using the stock options as a compensatory device the stock options should always be issued in a form of "call option" which gives the right the employees to buy a certain quantity of stocks at a certain specific time and at a certain specified price. The underlying security of compensatory stock options can be both common and preferred stocks of the employer corporation, however the option issuer can be the subsidiary or the affiliated entity of the employer corporation.

One of the most important features of the compensatory stock options is that the employee stock options may not be exercised immediately after granting, the option holders can exercise the stock option only specified later data. The time period when the employee should

[20] I.R.C. § 422 (b) (6) (1986).
[21] Kraus, *Supra* note 2.
[22] *Id.*

wait in order to be able to exercise the stock option calls vesting period. This approach is a cause of two reasons:

First, one of the most important doctrines of Contract law in common law jurisdictions is the doctrine of consideration. From the beginning of the seventeenth century, the common law courts started to use the term of "consideration"[23] according which the promise is not contractually binding if there is no exchange of promises. In the case of stock options, the option is an offer to sell the underlying stock which may be revoked before it is accepted (exercised) unless the offeror (option grantor) received consideration for the certain option. Since 1948, the U.S. courts abolished the employee stock options because of lack of consideration which the option granting corporation had to receive. The Court of Chancery of Delaware held that "[w]hile a corporation may under proper conditions grant an option to its officers to purchase its stock, the corporation must receive some consideration in return"[24]. The Supreme Court of Delaware held that "[a]s we view stock option plans, they are governed by no new or unusual rules, but by the familiar principles of contract. There must be a consideration for the granting of an option."[25]. However, some court found that as an adequate consideration can be considered the services which should be provided in the future by the option holder employee. The Supreme Court of Delaware held that

> [f]inally, we think that the lapse of time between the grant and exercise of the options, and the fact that the corporation to date has retained the services of nearly all of its employees to whom it granted options, places this case somewhat in the nature of a stock

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[23] E. Allan Farnsworth, Contracts, 25, Robert C. Clark, 6th ed., 2001.
[24] Rosenthal v. Burry Biscuit Corp., 60 A.2d 106 (Del. Ch. 1953).
[25] Gottlieb v. Hayden Chemical Corp., 90 A.2d 660 (Del. 1952).

purchase, the consideration for which is services to be performed in the future.[26]

The United States District Court for the Eastern District of Pennsylvania has found that the company receives the consideration for granted option only if the optionee remain employed in that certain company at least for one year and the vesting period should be extended at least for one year.[27] While the California courts of appeal authorized to exercise the options with installments and stated that the option received by the employee can be exercised totally after five years.[28]

The services rendered in the future do not constitute valid payment for underlying stocks under the following jurisdictions: California,[29] District of Columbia,[30] Idaho,[31] Alaska,[32] Missouri,[33] North Dakota,[34] Arizona[35] etc. The payment of the option exercise price by cash always satisfies the statutory requirement of consideration. However, the payment of the stock option exercise price by a promissory note is not a valid payment in some states.[36]

It is worth noting that for having a stock option plan or agreement it is required to have actions by the board of directors of the issuer company. In some cases, that actions can be required by an appropriately established committee of the board. In some states including

[26] Beard v. Elster. 160 A.2d 731 (Del. 1960).
[27] Holthusen v. Edward G. Budd Mfg. Co., 53 F. Supp. 488 (E.D. Pa. 1943).
[28] Newberger v. Rifkind, 28 Cal. App. 3d 1070, 104 Cal. Rptr. 663 (Ct. App. 1972).
[29] Cal. Corp. Code § 409(a)(1).
[30] D.C. Code Ann. § 29-101.17(b).
[31] Code § 30-1-621(2).
[32] Alaska: Alaska Stat. § 10.06.338(b).
[33] Mo. Ann. Stat. § 351.160.
[34] N.D. Cent. Code § 10-19.1-63[1].
[35] Ariz. Rev. Stat. § 10-621B.
[36] Kraus, *supra* note 2.

Delaware, the stock issuing is the responsibility of the board of directors, which can also be transferred to a committee of the board.[37] This rule works in Delaware if the corporation is incorporated on or after July 1, 1996, or in cases when the a corporation elects to be governed by this certain rule.[38] The delegation of this authority to a committee is only permitted if it is made very explicitly.[39]

[37] 8 Del. Code Ann. § 141(c).
[38] *Id.*
[39] *Id.*

CHAPTER II - THE HISTORY AND THE REGULATORY FRAMEWORK OF STOCK OPTIONS AS EMPLOYEE INCENTIVES IN THE UNITED STATES

2.1 The History of the First Regulations of Employee Stock Options

Despite the fact that the stock options as a form of compensation were being used already more than 100 years ago, they were not regulated until 1950.[40] The Internal Revenue Code of 1939 added section 130A in 1950. The main purpose of this section was to promote the use of employee stock options, under certain conditions, without tax burdens. More specifically, under the amendments, the gain would not be taxed if it is realized as an exercise of a "restricted stock option."[41] The result of this amendment was that during the 1950s roughly 300 companies reported a tremendous increase in the use of stock options.[42] The American Management Association reported that before 1954 almost 12 percent of companies had stock option plans which by the end of the 1950s tripled to 33 percent.[43]

During the 1960s, despite the appearance of new employee incentive devices (another form of long-term equity awards), stock option remained the most used forms of incentive awards. In addition, the restricted stock options were replaced by qualified stock options in the

[40] Wan-Kyu Park; Toni Smith, *On the Progress of Option-Regulating Legislation*, 2 ATA J. of Leg. Tax Res. 75, (2004).
[41] I.R.C. § 130A (1950).
[42] *Id.*
[43] Washington, G. T., and V. H. Rothschild, *Compensating the Corporate Executive* (New York, NY: The Ronald Press Company), 1962.

1960s, which were a large effort to decrease individual and corporate taxes and boost the economy.[44]

During the 1970s, performance shares appeared which was the first serious attempt to link the executives' compensation with companies' long-term profit performance.[45] The corporations started to grant performance shares to employees in addition to stock options and even 1980s, in spite the fact that there were already new types of incentive awards the stock option plans remained dominant and most granted long-term equity incentive award and in the 1990s roughly 75% of long-term equity awards were being made with stock options.

After 2005, the use of stock options decreased because of several events such as the changes in the accounting rules in 2006. The Financial Accounting Standards Board (FASB) implemented the ruling, according to which, all companies should expense the value of employee stock options.[46] Before these changes, the companies granted more stock options to their employees because of affirmative financial reporting.[47] After amendments to accounting rules in 2008 with the banking crisis, the market fell abruptly. The fall continued until early 2009. As a result, the Dow Jones Industrial Average dropped from approximately 11,000 in July 2008 to approximately 6,500 in March 2009.[48] The economy entered a great recession. The emergence from this was not easy and it was gradual. The Dow Jones Industrial average returned to approximately 17,000 which was approximately 160 percent increase from the low in March

[44] Park & Smith, *supra* note 40.
[45] Foote, George H., *Performance shares revitalize executive stock plans,* 1, McKinsey Quarterly, 2 (1974).
[46] How New Accounting Rules Are Changing the Way CEOs Get Paid, (May 03, 2006), http://knowledge.wharton.upenn.edu/article/how-new-accounting-rules-are-changing-the-way-ceos-get-paid/.
[47] *Id.*
[48] Joseph E. Bachelder III, *What Has Happened To Stock Options?*, October 2, 2014, https://corpgov.law.harvard.edu/2014/10/02/what-has-happened-to-stock-options/.

2009.[49] The Gear Recession in the U.S. decreased the use of stock options by U.S. corporations, however, after the financial crisis the use of stock option as an incentive device returned in its place and continues to remain one of the main ways of equity compensation.

2.2 The main types of abuses

The section to follow the focus will be on the main types of abuses of the use of stock options regarding option backdating and stock buybacks. This is of importance because these abuses were one of the main parts of the causes of the Great Recession in the United States. As we will see, the US experiences with abuses of stock buybacks and option backdating may teach invaluable lessons to other countries planning to take a similar path. The countries having no experience of the use of stock options should consider this possible abuses and should try to form these issues by adopting proper regulations.

2.2.1 Stock options backdating

2.2.1.1 What is meant by backdating

In 2003-2004, Erik Lie, Norwegian finance professor at the University of Iowa, did research about stock options and especially the dates of the granting of stock options in certain companies. In May 2005, Lie published an article entitled "On the Timing of CEO Stock Option Awards"[50] which established the hypothesis that some US companies backdated, without

[49] *Id.*
[50] Erik Lie, On the Timing of CEO Stock Option Awards, MANAGEMENT SCIENCE, Vol. 51, No. 5, May 2005, pp. 802–812.

disclosure, dates for grants of options to times when prices of heir stock were low.[51] In 2004, Lie sent a copy of his article to the SEC[52] after which SEC launched investigations on certain companies. In his article Dr. Lie used a sample of over 6000 stock options granted to executives between 1981 and 1992.[53] Dr. Lie's article did not mention any particular company[54], however, on March 18, 2006 the Wall Street Journal published an article, entitled "The Perfect Payday", where the authors of the article, Charles Forelle, and James Bandler mentioned five companies such as Affiliated Computer Services Inc. and UnitedHealth Group Inc. as they tested the hypothesis of Dr. Lie and found that the options were granted backdated, without any disclosure.

So, what is backdating? As it was already mentioned the stock options are normally issued "at-the-money", which means that the exercise price of the stock option is equal to the market price of the underlying stock at the date of grant. In cases when the officials of a company select a granting date prior to the actual granting date considering the low market price of the stock in that certain prior date without disclosing about this – is called as backdating.

So, the question is: When is the option backdating illegal and why? The answer is undisclosed backdating is illegal because it violates the SEC rules connected with the disclosure of the executives' compensation and also it violates accounting rules and tax laws. In 2003, the SEC approved new rules proposed and adopted by Nasdaq Stock Market and New York Stock Exchange, which required the shareholders' approval of equity compensation plans, including

[51] Steve Stecklow, "Option Study Becomes Required Reading," *Wall Street Journal*, May 30, 2006, p. B1.
[52] *Id.*
[53] Lie, *Supra* note 50, pp. 810.
[54] *Id.*

stock option plans. The rules state that companies must disclose in a press release the material terms of the award, including the recipient(s) of the award and the number of shares involved.[55]

The corporate executives involved in undisclosed backdating can lose their job because they are transferring the shareholders' wealth to themselves. When the option is exercised the company receives less than what the shares actually worth, they may be penalized for violation of tax and securities laws and in some cases, the involved executives may face even incarceration.

It is worth mentioning that option backdating is not only illegal, but also, it may abolish the main, incentive effect, of the stock option. By artificially lowering the actual exercise price of the option the executives get an immediate gain on paper. So, this shows that option backdating nullify the link between the executives' potential gain from an option award and the performance of the underlying asset.[56]

2.2.1.2 Hypothetical example of an option backdating

Assume that LLL, Inc. is a public corporation whose stocks are selling for $65 a share on November 10, 2016. On that day the CEO of the LLL, Inc. is granted to buy 100.000 shares of stock for $65 a share ("at-the-money"), however, the CEO, without disclosing, selects the proper grant day of January 29, 2016, when the market price of the stock was its lowest for that year, $35 per share. So we can see that this is a clear example of backdating, which gives the opportunity to the CEO to receive undisclosed gain $30 on paper per share which in total is $3.000.000. We can assume some other developments. For example, in a case when the vesting

[55] NYSE Listed Company Manual § 303A.08.
[56] JAMES M. BICKLEY & GARY SHORTER, *CONG. RESEARCH SERV., RL33926*, STOCK OPTIONS: THE BACKDATING ISSUE 1 (2008).

period for the stock option is 1 year and after that, during 5 years, the stock option holder CEO can exercise it. On January 29, 2017, the option becomes vested and in that case the CEO receives unrestricted right to buy the 100.000 shares of stock with only $35 per share. Assume that on January 20, 2022, the market price of the stock is $100 when the CEO still has a right to exercise the stock option and at that time the market price of the stock is $100. The CEO decides to exercise his options. In this case, he pays only $3.500.000 ($35 X 100.000) but he gets on the paper immediate gain of $6.500.000 ($65 X 100.000).

2.2.1.3 Empiric example of option backdating

Returning back to the options backdating scandal, it is worth mentioning that after Dr. Lie's article the SEC started Investigations against more than 140 companies.[57] Some of the companies where the Brocade Communications System, Inc., Apple, Inc., Comverse Technology ,Inc.,[58]. The SEC and DOJ filed civil and criminal charges against the executives of these companies.

The following example will not only show the reality happened during the option backdating scandal era but also will illustrate the essential violations of law and regulations because of option backdating. On April 24, 2007, the SEC alleged filed charges against two former senior executives of Apple, Inc., ("Apple"), Nancy R. Heinen and Fred D. Anderson in a matter involving improper stock option backdating .[59] In early January, 2001 Apple finalized terms of a 4.8 million option grant to six members of its Executive Team, from which 1 million

[57] Mark Maremont, Backdating Likely More Widespread, WALL ST. J., Aug. 18, 2009.
[58] Spotlight on Stock Options Backdating, Enforcement Actions Related to Options Backdating (displayed in reverse chronological order), https://www.for.gov/spotlight/optionsbackdating.htm.
[59] U.S. SECURITIES AND EXCHANGE COMMISSION Litigation Release No. 20086 / April 24, 2007.

options for Anderson and 400.000 for Heinen. On January 30, 2001, Heinen provided Steve Jobs the daily closing price of Apple shares and suggested Apple use earlier date and price for options grant of executive team. On January 30, 2001, in her email Heinen wrote:

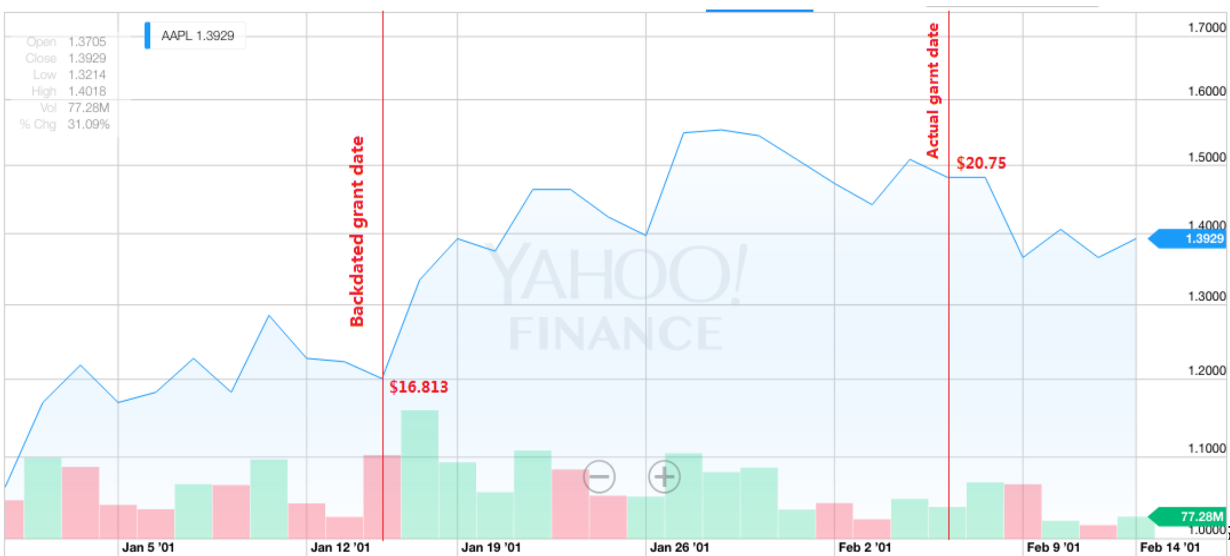
> There are 6.68m shares available for grant in the 1998 Executive Officer plan. To avoid any perception that the Board was acting inappropriately [sic] for insiders prior to Macworld announcements, I suggest we use Jan. 10, the day after your Macworld keynote, at $16.563. That was one of the lowest closes of the month, after the $14.875 price on Jan 2. I don't think the [Executive Team] would object to the $1.688 difference to avoid claims of inappropriate conduct.[60]

On January 31, Heinen emailed Anderson recommending Tuesday, January 17 or Monday, January 22 as the ostensible grant dates. The next day, Heinen told Anderson that Jobs had agreed to use the Apple's closing stock price on January 17, 2001.[61] Heinen arranged all paperwork necessary to submit to Apple's board of directors.[62] A lawyer of the legal department of Apple drafted a unanimous written consent ("UWC") for the Board members' signature, with "an effective date of Jan 17, 2001, priced at $16.813.[63] Heinen sent all necessary paperwork, including UWC to the board members of Apple and received it signed by them on February 7,

[60] Letter from Nancy R. Heinen, General Counsel of Apple, Inc. to Fred D. Anderson, Chief Financial Officer at Apple, Inc. (January 30, 2001).
[61] SEC litigation releases, Securities and Exchange Commission (Plaintiff) vs. Nancy R Heinen and Fred D. Anderson (Defendants).
[62] *Id.*
[63] *Id.*

2001, when the Apple's stock closed price was $20.75 per share, which was $3.94 higher than the January 17 price.[64]

The following chart shows above mentioned backdating process.



As a public company, Apple filed annual reports with the SEC, which included audited financial statements. The financial statement was certified by Apple's outside auditors, KPMG.[66] The public filings of Apple stated that the stock options were granted to the employees in accordance with the GAAP and during that time when Apple was accounted using APB 25[67] which required companies to record in their financial statements granted in-the-money stock options as an expense.[68] The options which were granted at lower prices than the market price was considered as an in-the-money option. So Apple had to record in its financial statement the

[64] *Id.*
[65] Apple Inc. (AAPL) share price, Jan. 1 – Feb. 15 2001, http://finance.yahoo.com/echarts?s=AAPL+Interactive#{"customRangeStart":978303600,"customRangeEnd":982191600,"range":"1d","didDisablePrePost":true,"allowChartStacking":true}.
[66] *Supra* note 61.
[67] *Id.*
[68] Accounting Principles Board Opinions, Opinion No. 25 (Accounting Principles Board 1972).

difference between the market price and the exercise (strike) price but failed to do it. For the fiscal year of 2001, which was ended on September 29 Apple failed to record the net loss to be understated by 10.77% and for the fiscal year 2002 the failure to record an expense caused operating income was 23.5% and net income roughly 5%.[69]

2.2.2 Stock Buybacks (Repurchase)

When companies have cash on hand, they can do three things with that. First, they can reinvest it, which means that they can hire more people, expand their employees' skills, increase their pay and benefits, make capital investments to make the company more competitive and create new products and services. Second, they can pay out cash dividends to shareholders, who can put money back into the economy or re-invest in some other places such as other companies or new ventures. Third, a company can repurchase its own shares which call stock buyback. There are two main types of stock buybacks: open market repurchases and tender offers. Corporations are mostly choosing to buybacks their stock from the open market because it that case they are not required to offer a premium over the current market price.[70] Companies are buying back their shares for different reasons. It is known, that one of the ways of raising capital by companies is issuing and selling common and preferred stocks. In some cases, companies return monies to the investors by buying back the sold shares. However, there can be many other reasons of stock buybacks, such as boosting financial ratios, undervaluation, and ownership consolidation. In most cases, companies are repurchasing their stocks from the open market for granting stock options to their employees or they are buying back their stocks when the

[69] *Supra* note 22.
[70] Charles J. Johnson & Joseph McLaughlin, Corporate Finance and the Securities Laws 797 (2d. ed. 1997).

employees are exercising their stock options. The companies are repurchasing their stocks because they want to increase EPS and raises the share price.

The buybacks are playing an anti-dilution role because when companies are repurchasing their shares the ESP and if companies issue new shares for granting stock options to employees or if employees exercise high amount of stock options, the stock of the companies will be diluted companies are doing buybacks to offset the dilution of earnings per share.

Since 1982 when the SEC instituted Rule 10b-18 based on the Securities Exchange Act, the companies are allowed to buyback their shares on the open market without any regulatory limitation.[71] Under the mentioned rule, the board of directors can authorize senior executives to repurchase the company shares at some certain amount and over some specific time or an open-ended period of time.[72] In addition to this, the companies are obliged to publicly announce the stock repurchase program and the management can start buying back the corporation's shares in large number and on any business day.

It is worth noting that, the SEC cannot charge a company being engaged in buybacks with stock manipulation because the Rule 10b-18 of Securities Exchange act provides "safe harbor" from liability for manipulation under sections 9(a)(2) of the Act.[73] However, there is a certain threshold, which is 25% of the average daily trading volume of the previous four weeks.[74] The SEC requires to disclose among other things, the total number of shares repurchased during

[71] 17 C.F.R § 240.10 b-18 (1999).
[72] *Id.*
[73] *Id.*
[74] *Id.*

the past quarter[75] but not daily ones, which means that without a proper investigation, the SEC cannot find out whether a company has breached the 25% threshold or not.[76] In connection with this, the SEC Chair Mary Jo White in a letter to the U.S. senator Tammy Baldwin admits that the SEC does not even collect data to find out the breaches of the mentioned limits of stock buybacks. In her letter, she states "[p]erforming data, analyzes for issuer stock repurchases presents significant challenges because detailed trading data regarding repurchases is not currently available."[77] These situations lead to several issues which are following:

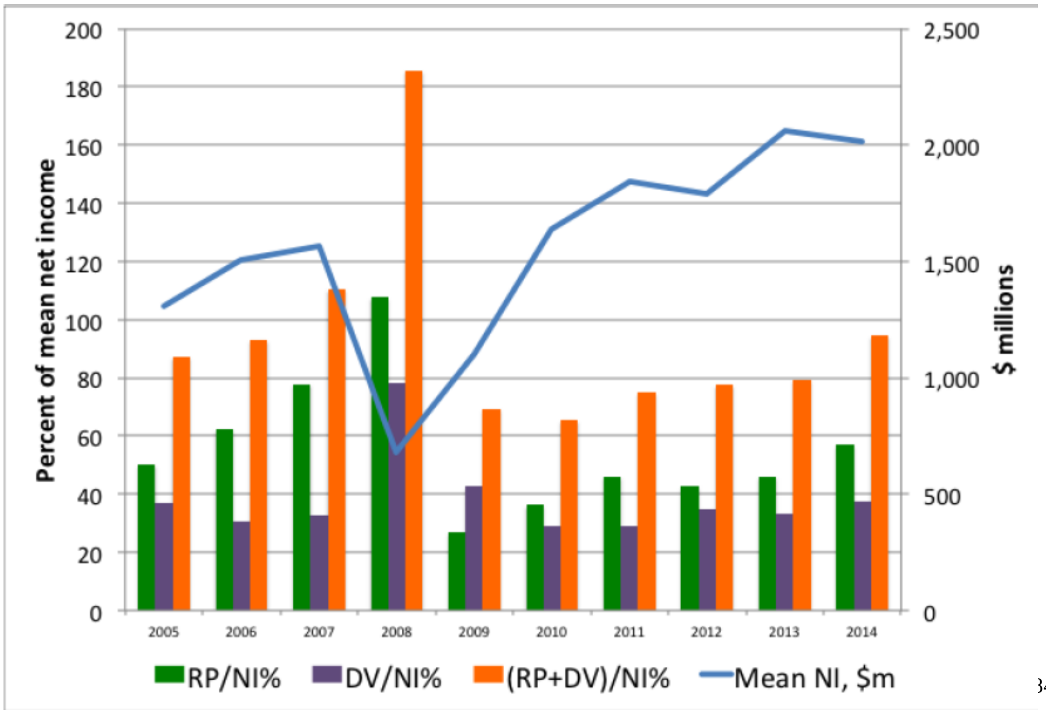
First, as it is already mentioned two significant reasons which make the companies repurchase their shares from the open market are employees stock option granting and stock option exercises by employees. Companies are making stock buybacks to avoid from dilution because if a company issue new stocks for granting stock options or if employees exercise their stock options there will be dilution. In addition to this, it is fairly important to mention about the effects of the stock buybacks. Because the quantity of outstanding shares is essential for calculating EPS, and the stock buybacks decrease the quantity of the outstanding stocks of a company, the outcome of the stock buybacks always increase the EPS. Moreover, the stock buybacks lead to an increase in stock price. As it is already mentioned the main idea of granting stock options to the employees is to motivate them to improve their performance, which will also have its impact on the stock price. By making stock repurchases the executives are artificially increasing the stock price and the main idea of the stock option loses its value.

[75] SEC releases, Purchases of Certain Equity Securities by the Issuer and Others, Release Nos. 33-8335; 34-48766; IC-26252; File No. S7-50-02, 2003.
[76] William Lazonick, Profits Without Prosperity, HARV. BUS. REV., Sept. 2014, at 46.
[77] Letter from Mary Jo White, Chairwoman of the Securities and Exchange Commission, to Tammy Baldwin, U.S. senator (July 13, 2015).

Second, executives are serving their own interests. In 2012, the 500 highest paid executives of U.S. public companies received roughly $30.3 million each from which 42% of compensation came from stock options.[78] From 2003 to 2012 449 publicly listed companies in the S&P 500 index used their 54% of earning for stock buybacks which are overall $2.4 trillion.[79] These companies paid only 37% of their earnings as dividends to their shareholders.[80] In addition to this 10 largest buybacks during which corporations spent overall $859 billion, which is the 68% of their combined net income, from 2003 until 2012.[81] During the same time period, the CEOs of that particular companies received a total of $168 million on average as compensation. From the mentioned compensation the 34% was in the form of stock options.[82] Each of the four highest paid executives of these companies received $77 million compensation during the mentioned 10 years, of which 27% were in stock options.[83]

The following bar chart clearly shows that between 2005 and 2014 the 458 companies in the S&P 500 Index every year, except 2009, used more than half of their profits to repurchase their stocks.

[78] Lazonick, *Supra* note 76.
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *Id.*



[84]

Please note: Repurchase (RP), Dividends (DV).

In fact, the buybacks become so big that even shareholders - the assumed beneficiaries of these all companies are getting worried. The chairman and CEO of world's largest investor BlackRock, states "It concerns us that, in the wake of the financial crisis, many companies have shade away from investing growth of their companies."[85]

[84] Standard and Poor's Compustat database, corrected from company 10-K filings by Mustafa Erdem Sakinç, The Academic-Industry Research Network. (http://www.theairnet.org/v3/backbone/uploads/2015/08/Lazonick-RESEARCH-UPDATE-2-20150806.pdf).

[85] Letter from Larry Fink, Chairman and Chief Executive Officer of BlackRock, Inc. to chief executives at S&P 500 companies (Mar. 21, 2014).

2.3 Say on pay, ISS recommendations, SEC Pay Ratio Disclosure

The financial crisis of U.S. , which begun in 2008[86] helped to find out the main issues and abuses connected with executives compensation during the time when the economy was performing poorly.[87] The main focus was on the poor performance of financial services and banking industry, which were believed that was the most responsible for the crisis.[88] As a response, the Congress drafted a legislation to regulate the financial and banking industry by required to do some certain disclosures for public corporations. The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd–Frank Act") is the product of the Senate, which was signed by U.S. president Obama on July 21, 2010.[89] The Subtitle E of Title IX of Dodd-Frank Act is about "Accountability and Executive Compensation"[90] (§§951-957).

Before enactment of the Dodd-Frank Act, since 2008 the ISS have started to present its recommendations concerning the right of advisory (non-binding) vote on executive compensation. These recommendations grant the shareholders a right to vote against the resolution (management proposal of executive compensation) when the boards have failed to

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[86] Phil Mattingly & Patrick O'Connor, Financial Overhaul Is Law, Now Comes Battle Over Its Rules, BLOOMBERG (July 21, 2010, 11:17 AM), http://www.bloomberg.com/news/2010-07-21/obama -signs-biggest-overhaul-of-financial-rules-since-the-great-depression.html.

[87] Ben Protess, In Split Vote, S.E.C. Adopts Rules on Corporate Pay, N.Y. TIMES, Jan. 26, 2011, at B4 ("Lawmakers are hoping to discourage companies from awarding lucrative packages that encourage risky behavior-a chief criticism of firms like Lehman Brothers and American International Group that collapsed during the financial crisis.").

[88] Jim Puzzanghera, Senate Passes Sweeping Financial Overhaul Legislation, L.A. TIMES, July 16, 2010, at BL.

[89] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 11 1-203, 124 Stat. 1376, 1376-2223 (2010) (codified in scattered sections of the code with the relevant section is at 15 U.S.C. § 78n-1 (2010)).

[90] *Id.*

care about investors' interests connected with executive compensation practices.[91] ISS provides five major principals to apply: (a) pay-for-performance, which means that the executive pay practices should be designed to attract, retain and appropriately motivate the key employees who over a long time drive the value creation over the long term.[92] There should be also considered the connection between pay and performance; the mix between fixed and variable pay; performance goals and guaranteed compensation; (b) avoid "pay for failure"; (c) keep an effective and independent compensation committee which should design executive compensation programs.[93]

This requirement propelled Institutional Shareholder Services Inc. (ISS) and other proxy advisers into a role with great influence over executive pay. ISS has taken the position that a substantial portion of equity awards should be performance-based. In some situations, as noted further below, ISS has recommended that 50 percent of equity awards should be performance based. In its report entitled, "Frequently Asked Questions on U.S. Compensation Policies" (March 28, 2014), under Q. No. 37, ISS notes that if it determines that a company's executive compensation program is not satisfactorily linked to performance:"[94]

After recommendations of proxy advisors, Dodd-Frank Act which is the first regulation of banking and financial industry after the financial crisis of U.S. presented the Section 951 of Dodd-Frank Act containing corporate governance provisions which require all public companies to adopt "say on pay" provisions.[95] The mentioned "say on pay" provisions require the public companies which are listed in U.S. stock exchanges to allow the shareholders of that certain

[91] Institutional Shareholder Services, U.S. Proxy Guidelines Summery, 2008.
[92] *Id.*
[93] *Id.*
[94] http://corpgov.law.harvard.edu/2014/10/02/what-has-happened-to-stock-options/.
[95] *Id.* § 951.

companies to have an advisory (non-binding) vote on executive compensation, at least once every three years.[96] In the U.S., the interest in say on pay existed before the passage of the Dodd-Frank Act, with several corporations adopted voluntarily say on pay provisions before the passage of the Dodd-Frank Act.[97] In addition to this, say on pay provision already existed for firms which under the Troubled Asset Relief Program ("TARP") received federal aid by the U.S. government.[98] Nonetheless, the Dodd-Frank Act was the first legal act to require all public companies listed on U.S. stock exchanges to adopt say on pay (advisory [non-bid] vote on executive compensation).[99] The Dodd-Frank Act contains several provisions connected with the mechanisms of say on pay voting.[100] Respecting the timing of the voting rights, the Dodd-Frank Act states:

> "Not less frequently than once every 3 years, a proxy or consent or authorization for an annual or another meeting of the shareholders for which the proxy solicitation rules of the Commission require compensation disclosure shall include a separate resolution subject to shareholder vote to approve the compensation of executives…".[101]

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[96] *Id.*
[97] *See* e.g. Gretchen Morgenson, Say-on-Pay Gets Support at Verizon, N.Y. TIMES, May 19, 2007, at Cl, available at http://www.nytimes.com/2007/05/19/technology/19verizon.html? r-l&scp =2&sq=&st-nyt (noting the approval of an adoption of a nonbinding say on pay shareholder vote at Verizon); Joseph E. Bachelder III, The "Restoring American Financial Stability Act" and Executive Pay, N.Y. L.J., June 28, 2010, at 3 ("[A]pproximately 80 companies had adopted some form of Say on Pay as of June 4, 2010. .. .").
[98] *See* Bachelder, supra note 47.
[99] *See* 15 U.S.C. § 78n-1 (2010).
[100] *Id.*
[101] *Id.*

In addition to this, in order to determine the voting frequency by shareholders, the Dodd-Frank Act states:

> Not less frequently than once every 6 years, a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the Commission require compensation disclosure shall include a separate resolution subject to shareholder vote to determine whether votes on the resolutions required under paragraph (1) will occur every 1, 2, or 3 years.[102]

Moreover, the Dodd-Frank Act requires disclosures in proxy materials regarding "golden parachute" agreements which are used to compensate the executives of absorbed companies. The mentioned disclosures are necessary when the shareholders vote on the proposed merger, total sale, acquisition or consolidation of the companies assets.[103] The Dodd-Frank Act requires disclosure of golden parachutes for all executives of the company, containing the total amount of parachute payments which may be paid to that executives.[104] It is also required a separate vote for each and every golden parachute agreement unless the agreement was subject to an earlier vote.[105] It is worth noting most of the times the golden parachutes contain also stock options.

It is worth mentioning that the Dodd-Frank Act mandates that votes on golden parachute agreements and executive compensation are not binding,[106] in other words, the votes cannot

[102] *Id.*
[103] *See* 15 U.S.C. § 78n-1 (2010).
[104] *Id.*
[105] *Id.*
[106] 15 U.S.C. § 78n-1 (2010).

overrule the decisions of the company or board of directors or the votes cannot limit the ability of shareholders making proposals of executive compensation including in the proxy materials.[107]

The reactions regarding say on pay provisions in the Dodd-Frank Act was different. Some commentators think that after this Act the shareholders will have right to voice their displeasure and in some cases, they can make changes.[108] However, other commentators believe that say on pay provisions can have only small or even no effect.[109]

The Dodd-Frank's say on pay provision has some critics. Several commentators believe that the regulations are not strict enough to make an essential change.[110][111] Some others think that the regulation gave the federal regulators so much freedom[112] that they may not adopt strong regulations which are the main purpose of the Dodd-Frank Act.[113]

There are some actual problems connected with say on pay provisions. Requiring a shareholder's vote on executives compensation once in every three years[114] may lead company management to focus on the short-term performance of the company to ensure the approval of the vote.[115] The short-term focus can be a cause of a huge risk in the long term.[116] During the

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107 *Id.*

108 *See*, e.g., David Nicklaus, New Law Has Effect on Executive Pay: Shareholders Now Have a Voice in the Process, ST. Louis POSTDISPATCH, Jan. 7, 2011, at Bl, available; Patrick May, Apple Execs Richly Rewarded for Banner Year, SAN JOSE MERCURY NEWS, Jan. 8, 2011.

109 Say on Pay: Will U.S. Shareholders Give Executives the Thumbs Up on Compensation?, KNOWLEDGE WHARTON (Dec. 8, 2010), http://knowledge.wharton.upenn.edu/article.cfm?articleid= 2649.

110 As I do, because I believe that having an advisory vote (non-binding) is not enough to be a game changer.

111 *See*, e.g., William D. Cohan, Op.-Ed., Make Wall Street Risk It All, N.Y. TIMES (Oct. 7, 2010), http://opinionator.blogs .nytimes.com/2010/10/07/make-wall-street-risk-it-all.

112 *Supra* note 70.

113 *Id.*

114 *See* 15 U.S.C. § 78n-1(a)(1) (2010).

115 *Supra* note 59.

financial crisis in the U.S., one of the most blamed things was the prioritization of the short-term performance.[117]

The Dodd-Frank Act gives the right to SEC to exempt companies to follow the say on pay provisions requirements when it is an unfair burden for small issuers.[118] Currently, the last version of SEC regulation requires all corporations to follow the say on pay provisions, regardless of size.[119]

After the passing of the Dodd-Frank Act it is passed already 6 years and after the adoption of say on pay rules by SEC it is passed already 5 years and in 2015 only 2% of US public companies have failed to get the support of the majority of shareholders for the approval of executive compensation packages.[120]

116 Paul Hodgson, Greg Ruel & Michelle Lamb, Wall Street Pay: Size, Structure and Significance for Shareowners, 2010 COUNCIL OF INSTITUTIONAL INVESTORS 20.
117 *Id.*
118 *Supra* note 59.
119 U.S. SECURITIES AND EXCHANGE COMMISSION, SEC Adopts Rulesfor Say-on- Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act, Press Release 2011-25 (Jan. 25, 2011),http://www.sec.gov/news/press/2011/2011-25.htm [hereinafter SEC Press Release]; see also U.S. Securities and Exchange Commission, Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Exchange Act Release No. 33-9178 (Jan. 25, 2011), available at http://www.sec.gov/ rules/final/2011/33-9178.pdf.
120 EMILY CHASAN, Say-on-Pay Vote Failures Remain Rare, WALL ST. J., May 19, 2015, http://blogs.wsj.com/cfo/2015/05/19/say-on-pay-vote-failures-remain-rare/.

CHAPTER 3. LESSONS FOR ARMENIA

3.1 The Use of Stock Options in Armenia and the Legal Issue

As it has been mentioned in previous chapters, stock options are playing an essential role in employees' compensation and are one of the main ways of long-term equity compensations. However, in some – especially developing economies and legal systems, the use of stock options as employee compensation and the incentive is either completely unknown or is underdeveloped.

In the Republic of Armenia, the stock options as an incentive for employees and as compensation are not being used because of several reasons. One of the most significant reasons is of a regulatory nature because especially corporate and labor law are ill-suited for the introduction and spreading of such a corporate culture.

For presenting the legal issues of Armenian connected with stock options there should be a short introduction of the corporate law of the Republic of Armenia. As in most post-Soviet countries, Armenia also has three main types of companies which are being used for commercial purposes: the limited liability company, the closed joint stock company and the open joint stock company. The limited liability and the closed joint stock companies are private companies, meaning that their shares are nor being sold on stock exchanges. The only type of company in Armenia which is, however, only considered to be a public company is the open joint stock company. It is worth noting that there are several public companies registered in the Republic of Armenia, however, currently there are only five properly listed companies on the only Armenian stock exchange, the Nasdaq OMX Armenia.[121]

[121] Market Data, https://nasdaqomx.am/en/market.htm (as of March 26, 2016).

After the dissolution of the Soviet Union, the first Joint Stock Companies' law was adopted in Armenia in 1996.[122] Article 43 of this statute contained provisions about employee stocks which stated that the employees of companies can receive common or preferred stocks of the company.[123] It is worth mentioning that the mentioned common or preferred stocks should not be granted as compensation. In 2001, the Parliament of Republic of Armenia adopted a new law, about Joint Stock Companies. Article 41 of this new law is literally the same as article 43 of previous Joint Stock Companies Law.[124] In other words, the law has not changed for the better and the regulatory constraints survived up until today. In fact, Article 41 creates several obstacles for the use of stock options in the Republic of Armenia as employee incentives. As this thesis is aimed at proposing a new, better framework for Armenia based on US experiences, the most important obstacles should now be taken a look at.

First, the Article provides that companies can grant stocks to their employees only in the manner stipulated by the Charter.[125] This means that companies should regulate the stock granting with their Charters. The mentioned requirement seemingly gives a complete flexibility to companies yet what in a country without any experiences with stock option plans might not be the right solution. Instead of complete freedom, more prescriptive drafting of the Joint Stock Companies Law might be beneficial, to provide some guidance and encouragement to companies.

[122] HH Orenqy Bazhnetirakan Ynkerutyunneri Masin, [Joint Stock Companies Law of Republic of Armenia], HH Pashtonakan Teghekagir, [HH PT], [Official Records of the Republic of Armenia], 1996, HO-51.
[123] *Id.* art. 43.
[124] HH Orenqy Bazhnetirakan Ynkerutyunneri Masin, [Joint Stock Companies Law of Republic of Armenia], HH Pashtonakan Teghekagir, [HH PT], [Official Records of the Republic of Armenia], 2001, HO-232, art 41.
[125] *Id.* art. 41 (1).

Secondly, in addition to this, the Article defines the maximum quantity of stocks which can be granted to employees. The granted stocks cannot be more than 25% of company's charter capital.[126] This limitation prevents companies to grant employees as many stock options as needed. For granting stocks to the employees it is required by the Law to have a special shareholding fund,[127] which is an extra administrative burden for companies.

Another issue created by the mentioned article is that it requires granting employees only repurchased stocks.[128] As it is already mentioned in previous chapters of this paper, the companies are buying back their stocks to potentially grant them to their employees because issuing new shares will lead to dilution. This is a major problem for private companies – that form the overwhelming part of the Armenian business sector – because their shares are not traded publicly on stock exchanges and thus the only way to reward employees with shares would be to issue new shares – something that is explicitly prohibited by the Law. It is worth mentioning that even if private companies issue new stocks for granting stock options to their employees as compensation and as an incentive, it will face two further major legal issues.

First, in spite the fact that the Joint Stock Companies' law of the Republic of Armenia contains provisions about employee stocks, there is no word about stock options. In the concept suggested by Armenian law, there is no the essential device, options, which is the crucial part of the stock option. So this means that there are no employee stock options under Armenian law. It can even be said that the concept suggested by Armenian legislator is not even a way of equity compensation of employees because the labor code forbids to do so. The Labor Code of the

[126] *Id.*
[127] *Id.*
[128] *Id.*

Republic of Armenia explicitly states that it is forbidden to compensate employees with securities.[129]

Second, if companies issue new stocks for granting them to their employees, they – the employees – should pay for that because the Article 42 of Joint Stock Companies' law requires payment for every single stock issued by joint stock companies. The payment can be in different ways, such as with assets including cash, securities, property rights, and intellectual property rights.

In Armenia, one of the biggest issues of corporate law which has its negative impact on the use of stock options is preemptive rights. Historically, this used to be an issue also in the U.S. yet where it was fixed by abolishing the preemptive right. Currently, in most of the states of U.S. preemptive rights do not exist, unless the article of incorporation of that certain company explicitly provides them.[130] These rights which are also traditional common law rights [131] require that any shares issued by a company initially, must first be offered to the existing shareholders.[132] The existence of this common law concept is sought to protect existing shareholders from dilution of their shares ownership.[133] This creates a huge problem for closed joint stock companies which wants to grant stock options to their employees because in every case the existing shareholders can buy that certain shares before the stock option granting. In addition to this, there is one more issue regarding with stock allocation. The Armenian corporate

129 Hayastani Hanrapetutyan Ashkhatanqayin Orensgirq [HH AKH] [Labor Code] art. 192 (Arm.).
130 Kraus, *Supra* note 2, p. 2-5.
131 *Id.*
132 HH Orenqy Bazhnetirakan Ynkerutyunneri Masin, [Joint Stock Companies Law of Republic of Armenia], HH Pashtonakan Teghekagir, [HH PT], [Official Records of the Republic of Armenia], 2001, HO-232, art 8 (3).
133 Jerry W. Markham, Thomas Lee Hazen, Corporate Finance: Cases and Materials 29, 2004.

law requires to during the funding the company all shares of the company should be allocated between the founders of the company. This means that the companies which are just funding cannot grant stock options to their employees. Of course, most companies which grant stock options to their employees are not just funded companies, but the mentioned role of Armenian corporate law prevents the use of stock options by companies which are just being founded.

Another corporate law issue preventing the use of stock options in Armenia is that companies are allowed to issue only one type of common stock.[134] This means that companies do not have a right to issue different types of common stocks and grant them to the employees. This creates non-flexibility for companies regarding option granting and companies have to grant either, that the only type of common stocks to their employees or resort to different types of preferred stocks. Granting preferred stocks to the employees is also full of issues because the Armenian corporate law defines a threshold for the quantity of preferred stocks of companies. The Armenian companies cannot issue preferred stocks more than 25% of their charter capital. This leads to new issue connected with equity financing, because as it is known one of the main ways of getting money for corporations is selling ownership interests (equity)[135]. In many cases, the corporations are issuing and selling their preferred shares to the investors. So if companies only can issue one type of common stock and cannot grant stock to their employees for more than 25% of their capital defined in the charter that means obstacles. Either the companies should not grant any stock option with preferred stock, but they should grant stock options with the only type of common stock or they should not have any equity investment. Instead of this, they can grant a stock option to their employees with that very limited preferred stocks. As we can conclude, Armenian company law itself creates serious obstacles for using stock option plans for

[134] *Id.*
[135] Eric A. Chiappinelli, Cases and Materials on Business Entities 153, (2006).

rewarding employees. Therefore, the Armenian lawmaker should in the future devote closer attention to this specific problem given that a proper solution would be beneficial not only to companies, investors, and employees but eventually also the entire economy.

3.2 Lessons Learned from U.S. and Recommendations

Based on the previous analysis, one could realize that Armenian law would have to be meaningfully amended to make use of stock option plans as employee reward and incentive mechanisms possible. The most important and urgent changes that should be considered would be the following.

The most important amendment which should be done in Armenian legislation is connected with the Labor Code. As it is already mentioned, the Labor Code of the Republic of Armenia does not permit companies to compensate their employees with securities, including stocks. For this reason, the Armenian legislator should amend the 2nd part of Article 192 of the Labor Code to provide that the employees of companies can also be compensated with stocks. Without this amendment, employee stock options cannot be used in Armenia because compensation is one of the main parts of the concept of stock options.

In addition to this, there should be several amendments in corporate law of the Republic of Armenia. More specifically article 41 of Joint Stock Companies' law of Republic of Armenia should be completely rewritten. The provision requiring stipulation in companies' charters about stocks granting to the employees should be abolished for the following reasons. First, this requirement creates non-flexibility for companies because for every single stock option or stock option plan with different terms the companies should make amendments to their charter.

Amendments to the charter of the company can only by a decision of the general meeting of shareholders, which can be adopted by a 3/4s vote of the shareholders.[136]

Second, this requirement is also an extra expense for companies because every time when companies amending their charters they should pay some certain state fee[137] for the registration of the amendment of the charter in the State Register of the Legal Entities of the Ministry of Justice of the Republic of Armenia.[138]

Another amendment that should be done in the article 41 of Joint Stock Companies law of Republic of Armenia is to abolish the requirement of having a special fund of employee shareholding.

The threshold defined in Article 41 for the quantity of shares that can be granted to employees of companies should be abolished because as we can see from the U.S. experience the use of stock options was so successful in some companies that the employees owned more than 80% of ownership.

The major issues that U.S. faced during the use of stock options which is may even be an issue for Armenia too are buybacks and backdating. The U.S. experience should be a lesson for countries like Armenia which does not have any experience with the use of stock options as employee incentives because U.S. has the longest experience regarding stock options. Armenian legislator should not only make the use of stock options possible by making amendments in the

[136] HH Orenqy Bazhnetirakan Ynkerutyunneri Masin, [Joint Stock Companies Law of Republic of Armenia], HH Pashtonakan Teghekagir, [HH PT], [Official Records of the Republic of Armenia], 2001, HO-232, art 15 (1).

[137] AMD 10.000 ($20.74 as of 25.03.2016 (calculated with the rates of Central Bank of Republic of Armenia)).

[138] HH Orenqy Petakan Turqi Masin, [Law on State Duty of Republic of Armenia], HH Pashtonakan Teghekagir, [HH PT], [Official Records of the Republic of Armenia], 1997. HO-186, art.16 (1.1.).

corporate and labor law but also should take care of possible abuses regarding the use of stock options, more specifically there should be regulatory leverages for stock buybacks and option backdating.

As it is mentioned in the second chapter of this paper one of the main issues that the U.S. faced connected with the use of stock options was stock buybacks. According to the Armenian corporate law, one of the exclusive rights of the board of directors is buying back the stocks issued by that certain company.[139] This may be a problem because, as we could see from U.S. experiences, the board of directors could spend more than half of the profit of the company buying back companies' stocks led by the motivation to perpetuate themselves in office and strengthen their control over the company.

Moreover, the main purpose of repurchasing companies' stocks is granting stock options to executives and boosting EPS. This issue can also happen in Armenia and in the lack of appropriate explicit rules the possibility to use of stock options may skyrocket buybacks. When the use of stock options in Armenia become possible the board of directors of Armenian companies can do many buybacks with the companies' profits for granting stock options themselves and during exercising and selling the stocks they can again do stock buybacks for artificially increasing the stock price. This will abolish the main idea of having a stock option because the executives will not work harder and efficient for busting the stock price of companies, and as a result, the stock option will not work as incentives but will be reduced to mere compensation.

[139] HH Orenqy Bazhnetirakan Ynkerutyunneri Masin, [Joint Stock Companies Law of Republic of Armenia], HH Pashtonakan Teghekagir, [HH PT], [Official Records of the Republic of Armenia], 2001, HO-232, art 84 (i).

This problem is not even solved in the U.S. After the official end of the Great Recession seven years passed, but the stock market is booming again[140] and one of the main causes of this is stock buybacks. As it was mentioned in the previous chapter of this paper there is a regulatory issue connected with disclosures of stock buybacks, however, the SEC is trying to find a solution for an effective and proper disclosure of stock repurchase.[141] The Armenian securities law does not even require any disclosure for stock buybacks. This situation is full of issues which should be changed by adding an article on the Law of Securities Market of Republic of Armenia about disclosures regarding stock repurchases. The frequency of disclosure of stock buyback disclosure should be defined so that the investors be fully informed about the companies in which they invest.

Another issue which U.S. faced, but Armenia may face is option backdating. As it was mentioned in the previous chapter of this paper, stock backdatings are illegal in the U.S. when they are being done without disclosure because they may violate the accounting rules and securities regulations. One may legitimately presume that Armenia will as well face the backdating issue because according to the Armenian corporate law, determination of conditions of executive compensation is an exclusive right of a general meeting of shareholders.[142] Of course, the issues to be discussed at the general meeting of shareholders are suggested by the board of director, but the only and final decision make shareholders. This means that only shareholders can authorize the grant (stock options) of executives and because in cases of option

[140] Lazonick, *Supra* note 76.
[141] Kimberly S. Johnson, "SEC Mulling Buyback Disclosures, Says Mary Jo White", Feb. 19, 2016, http://blogs.wsj.com/cfo/2016/02/19/sec-mulling-buyback-disclosures-says-mary-jo-white/.
[142] HH Orenqy Bazhnetirakan Ynkerutyunneri Masin, [Joint Stock Companies Law of Republic of Armenia], HH Pashtonakan Teghekagir, [HH PT], [Official Records of the Republic of Armenia], 2001, HO-232, art 67 (u).

backdating the stock option receivers pay company less then actually they should the probability of option backdating in Armenia is less the in the U.S. However, it is important to mention that even if the probability of option backdating is Armenia is less, Armenian legislator should require a disclosure about option backdating for all companies because in that cases the companies may violate accounting principles which may also lead to violation of tax law.

As it is stated in chapter II of this thesis, after the Greate Recession in U.S. the American congress adopted Dodd-Frank Act which contains provisions affecting executives compensations.[143] These provisions are adopted to prevent the abuses connected with executives compensation, including stock options. However, there is no sense to adopt some of that provisions in Armenian corporate and securities law because of several reasons.

First, the requirement of shareholders' advisory vote on executives compensation (say on pay)[144] is not necessary to have in Armenian corporate law because Armenian corporate law grants the right of determination of terms of executive compensation to a general meeting of shareholders.[145] This means that in any case shareholders of a company makes a decision about executives compensation and their role is much bigger in Armenian corporate law than in U.S. Thus this rule of Armenian corporate law should be kept.

Second, the requirement of disclosure of ratio of compensation of chief executive officers and median compensation of employees are also not necessary because this rule is provided to inform shareholders for voting say on pay. More specifically, the main aim of this rule is to

[143] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 78o).
[144] *Id.*
[145] HH Orenqy Bazhnetirakan Ynkerutyunneri Masin, [Joint Stock Companies Law of Republic of Armenia], HH Pashtonakan Teghekagir, [HH PT], [Official Records of the Republic of Armenia], 2001, HO-232, art 67 (u).

provide information to shareholders, which can help them to calculate the compensation of CEOs' which is important for shareholders to know before voting for executives compensation. In this case also because the essential role of the a general meeting of shareholders in executives compensation role there is no need to adopt the same rule in Armenia. The shareholders during general meeting decide the terms of the compensation of executives and in that cases, there is no need to inform them about anything connected with executives compensation.

CONCLUSION

The research has discussed the use of stock options in the United States of America. as employee and executive compensation and incentive with a focus on what practical guidance and lessons can be transplanted into Armenia. It is worth noting that this thesis outlined the existing legal issued connected with the use of employee stock options.

This study briefly introduced derivatives and more specifically options and their use in business environment. In addition, it was analyzed the several legal issues connected with the use of stock options such as the issues of the doctrine of consideration. For this issue, it was presented the existing case law in different states of United States and it was showed the different approaches of American courts to this issue. In the first Chapter of this thesis, it was presented the tax benefits for the certain type of stock options which the legislator calls Incentive Stock Options. This type of options is also famous with the name of qualified stock options because they need to be qualified to get the defined tax benefits provided in the Internal Revenue Code. In this part of this paper, it was also discussed the stock options which are not qualified for tax benefits (non-qualified stock options). Such options are not required to comply the requirements specified in Internal Revenue Code. The approach of U.S. legislator of giving tax benefits for Incentive Stock Options stimulates the use of such devices.

In the Second Chapter of this thesis, it was presented the first regulations of employee stock options which are again mostly connected with the tax issues of these devices. In this chapter also parents the use of stock options by U.S. corporations in a chronological way. The main abuses discussed in this chapter are option backdating and stock buybacks. Stock buybacks still remain a major issue for many U.S. corporations and investors. Executives continue to use a large amount of money from the profits of companies to repurchase companies own stocks fro the open market. The connection with stock buybacks and stock options is that in most cases companies are buying their own shares for granting stock options to their employees and in cases when the employees are exercising their stock options. As an excuse many executives are presenting the dilution however them in most cases the main aims of stock buybacks are increasing the stock price and EPS. By increasing the stock price by doing a mere stock repurchase stock options lose their essence. As a lesson from U.S. in a connection with stock buybacks in this thesis, it is recommended to define some certain threshold for allowed stock buybacks and require companies to disclose the information about the amount of the stock repurchases.

The other abuses discussed in this thesis are connected with option backdatings which were so big issue that SEC launched investigations in hundreds of U.S. companies. The thesis presents the hypothetical and empiric cases of option backdating to illustrate the issue clearly. The option buybacks can be an issue in every country where companies are granting stock options to their employees.

In the last chapter, it was presented the analysis of Armenian legislation the possibility of the use of stock options and the U.S. experiences which can be lessons for Armenia. The analysis of Armenian legislation showed that currently it is practically impossible to use stock options as an employee incentive. This is connected with the legislative issues. This study concluded that there is a need to make amendments in the Armenian labor and corporate laws to make the use of stock options possible. However, it was also found that the structure of Armenian corporate law makes the companies, investors, shareholders and employees to avoid some issues and abuses which U.S. faced.

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