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Client Alert

A report
for clients
and friends
of the firm July 2003
(as updated for subsequent
Nasdaq amendments, as of
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Shareholder Approval of Equity Compensation Plans Under the Final NYSE and Nasdaq Rules

On June 30, 2003, the Securities and Exchange Commission ("SEC") approved new rules adopted by the New York Stock Exchange, Inc. ("NYSE") and The Nasdaq Stock Market, Inc. ("Nasdaq") requiring shareholder approval of equity compensation plans, including stock option plans, and certain other actions taken with respect to those plans. The NYSE and Nasdaq rules are substantively similar, but there are some differences and the NYSE rule is more detailed. The new requirements are effective immediately, subject to a short comment period.

The final rules tighten the prior shareholder approval requirements and eliminate certain exceptions often relied upon by listed companies. The final rules also provide a meaningful response to shareholders' demand for enhanced corporate governance practices of publicly-traded companies, particularly related to the use of unapproved equity arrangements that result in additional shareholder dilution.

A table comparing certain provisions of the final rules appears at the end of this Client Alert.

NYSE Rule

The final NYSE rule requires shareholder approval of all "equity compensation plans" and "material revisions" to such plans, subject to limited exemptions. The new rule, which is written in a more "plain-English" format than the prior rule to enhance understanding of the rules, replaces the existing NYSE pilot program with respect to the definition of "broadly-based" stock option plans and closes the loophole that allowed companies to avoid shareholder approval of plans that authorized only the delivery of treasury shares.

Equity Compensation Plans. Under the NYSE rule, an "equity compensation plan" is a plan or other arrangement that provides for the delivery of equity securities (either newly issued or treasury shares) of the listed company to any employee, director or other service provider (*e.g.*, consultants) as compensation for services. A compensatory grant of options or other equity securities that is not made under a formal plan (*e.g.*, a stock option award made pursuant to the terms of an employment agreement or a stand-alone stock option agreement) is within the definition of "equity compensation plan" for these purposes.

The following plans are not considered "equity compensation plans" for purposes of the NYSE rule even if the brokerage and other costs of the plan are paid for by the listed company:

- plans that are made available to shareholders generally, such as a typical dividend reinvestment plan; and
- plans that merely allow employees, directors or other service providers to elect to buy shares on the open market or from the listed company at fair market value, regardless of whether the shares are delivered immediately or on a deferred basis or the payments for the shares are made directly or by giving up compensation that is otherwise due (for example, through payroll deductions).

Planning Note: *Plans that do not provide for the delivery of equity securities of the listed company (e.g., plans that pay in cash) do not require shareholder approval under the NYSE rule. For example, a listed company could adopt a restricted stock unit plan that pays out solely in cash without shareholder approval. This may be particularly useful if the proposed changes to accounting standards are adopted or the listed company applies SFAS No. 123, Accounting for Stock Based Compensation, as amended. Currently, such a plan could result in variable accounting under APB Opinion No. 25.*

Exemptions. Certain grants, plans and amendments are exempt from the shareholder approval require-

ments if the company's independent compensation committee or a majority of the company's independent directors approve such grants, plans and amendments and the company utilizing the exemption provides written notice to the NYSE.

- **Employment Inducement Awards.** A grant of options or other equity-based compensation as a material inducement to a person or persons being hired by the listed company or one of its subsidiaries, or being rehired following a *bona fide* period of interruption of employment, are exempt from the shareholder approval requirements. Inducement awards include grants to new employees in connection with a merger or acquisition. Promptly following a grant of any inducement award in reliance on this exemption and, in addition to written notice to the NYSE, the listed company 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.

  Planning Note: *This exemption does not apply to grants to non-employee directors or other non-employee service providers.*

- **Mergers and Acquisitions.** Shareholder approval is not required to convert, replace or adjust outstanding options or other equity-compensation awards to reflect a corporate transaction. In addition, shares available under pre-existing shareholder-approved plans acquired in corporate mergers and acquisitions may be used for certain post-transaction grants of options and other awards with respect to the equity of the entity that is the listed company after the transaction, either under the pre-existing plan or another plan, without approval by the acquiring company's shareholders, provided:

  - the number of shares available for grants is appropriately adjusted to reflect the transaction;
  - the time during which those shares are available is not extended beyond the period when they would have been available under the pre-existing plan, absent the transaction; and
  - the options and other awards are not granted to individuals who were employed, immediately before the transaction, by the post-transaction listed company or by entities that were its subsidiaries immediately before the transaction.

  A plan adopted in contemplation of the merger or acquisition would not be considered "pre-existing" for purposes of this exemption.

  Any shares reserved for listing in connection with a transaction pursuant to either of these exemptions would be counted by the NYSE in determining whether the transaction involved the issuance of 20% or more of the company's outstanding common stock and thus required shareholder approval.

- **Certain Employee Benefit Plans.** The following types of plans regulated under the Internal Revenue Code and Treasury Regulations (and material revisions thereto) are exempt from the shareholder approval requirement:

  - retirement plans intended to meet the requirements of Section 401(a) of the Internal Revenue Code;
  - employee stock purchase plans intended to meet the requirements of Section 423 of the Internal Revenue Code; and
  - "parallel excess plans" (*i.e.*, ERISA-covered pension plans that allow participants to receive benefits that can not be provided under tax-qualified retirement plans as a result of certain limits under the Internal Revenue Code and Treasury Regulations relating to contributions, pensionable earnings and plan benefits (collectively, the "Limits") provided such parallel excess plan (1) covers all or substantially all employees of an employer who are participants in the related tax-qualified plan whose annual compensation is in excess of the annual limit on pensionable earnings; (2) has terms that are substantially the same as the tax-qualified plan that it parallels, except for the elimination of the Limits and the limitation described in clause (3); and (3) provides that no participant receives employer equity contributions under the plan in excess of 25% of the participant's cash compensation).

  An equity-compensation plan that provides non-US employees with substantially the same benefits as a tax-qualified retirement plan or a qualified employee stock purchase plan or parallel excess plan that the listed company provides to its US employees, but for features necessary to comply with applicable foreign tax law, is also exempt from the shareholder approval requirement.

  Planning Note: *The NYSE has proposed a revised definition of "independent director" as well as other rules relating to the composition and functions of compensation committees. Nasdaq has a similar proposal and the SEC is working with both the NYSE and Nasdaq to harmonize the proposals.*

Material Revisions. The NYSE rule also includes a non-exclusive list of "material revisions" to a plan that would require shareholder approval:

- a material increase in the number of shares available under the plan (other than an increase solely to reflect a reorganization, stock split, merger, spinoff or similar transaction);
- an expansion of the types of awards available under the plan;

- a material expansion of the class of employees, directors or other service providers eligible to participate in the plan;
- a material extension of the term of the plan;
- a material change to the method of determining the strike price of options under the plan; and
- the deletion or limitation of any provision prohibiting repricing of options.

An amendment will not be considered to be a "material revision" if it curtails rather than expands the scope of the plan in question.

If a plan contains a formula for automatic increases in the shares available (sometimes called an "evergreen formula") or for automatic grants pursuant to a formula (sometimes called a "formula plan") and the plan does not contain a maximum number of shares that are available under the plan, each such increase or grant will be considered a revision requiring shareholder approval unless the plan has a term of not more than 10 years. Examples of automatic grants pursuant to a formula are (1) annual grants to directors of restricted stock having a certain dollar value, and (2) "matching contributions," whereby stock is credited to a participant's account based upon the amount of compensation the participant elects to defer.

Planning Note: *Plans with an evergreen formula and formula plans can be amended without shareholder approval to include a term of not more than 10 years from the date of its original adoption or, if later, the date of its most recent shareholder approval, to avoid the need for shareholder approval of future automatic increases or grants. The timing of such an amendment depends upon whether the formula plan has been previously approved by shareholders, as described below.*

Each grant under a discretionary plan *(i.e.*, a plan that contains no limit on the number of shares available and is not a formula plan) will require separate shareholder approval regardless of whether the plan has a term of not more than 10 years. A requirement that grants be made out of treasury or repurchased shares will not, in itself, be considered a limit or pre-established formula so as to prevent a plan from being considered a discretionary plan.

Repricings. Most institutional shareholders have long requested that companies adopt policies requiring shareholder approval of stock option repricing programs or specifically prohibit repricing in their equity plans. The NYSE rule provides that a plan that does not contain a provision that specifically permits repricing of options will be considered as prohibiting repricing. Accordingly, any actual repricing will be considered a material revision of a plan requiring shareholder approval even if the plan itself is not revised.

For this purpose, "repricing" includes any of the following or any other action that has the same effect:

- lowering the strike price of an option after it is granted;
- any other action that is treated as a repricing under generally accepted accounting principles; or
- canceling an option at a time when its strike price exceeds the fair market value of the underlying stock, in exchange for another option, restricted stock, or other equity, unless the cancellation and exchange occurs in connection with a merger, acquisition, spin-off or other similar corporate transaction.

Planning Note: *A cash buyback of an outstanding stock option would likely not be treated as a repricing. On the other hand, it is not entirely clear whether a cancellation of stock options and new grant of stock options more than six months after the cancellation date would be treated as a repricing for these purposes.*

An option repricing program that was effected pursuant to an exchange offer that commenced prior to June 30, 2003 is not impacted by the new rule.

Transition Rules. After discussions with the SEC, the NYSE included a provision in the final rules which clarify when shareholder approval is required for plans adopted before the effective date of the new rules. Generally, a plan that was adopted before the date of the SEC's approval of the NYSE rule will not be subject to shareholder approval unless and until it is materially revised.

In the case of a discretionary plan, whether or not previously approved by shareholders, additional grants may be made without further shareholder approval only for a limited transition period, and then only in a manner consistent with past practice. In applying this rule, if a plan can be separated into a discretionary plan portion and a portion that is not discretionary, the non-discretionary portion of the plan can continue to be used separately, under the appropriate transition rule. For example, if a shareholder-approved plan permits both grants pursuant to a provision that makes available a specific number of shares, and grants pursuant to a provision authorizing the use of treasury shares without regard to the specific share limit, the former provision (but not the latter) may continue to be used after the transition period, under the general rule above.

Similarly, in the case of a formula plan that either (1) has not been previously approved by shareholders or (2) does not have a term of 10 years or less, additional grants may be made without further shareholder approval only for a limited transition period. As noted above, a shareholder-approved formula plan may continue to be used after the end of the transition period if it is amended to provide for a term of 10 years or

less from the date of its original adoption or, if later, the date of its most recent shareholder approval. Such an amendment would not itself be considered a "material revision" requiring shareholder approval. In addition, a formula plan may continue to be used, without shareholder approval, if the grants are made only from the shares available immediately before the effective date of the final rules, in other words, based on formulaic increases that occurred prior to such effective date.

The limited transition period for purposes of discretionary and formula plans will end upon the first to occur of:

- the listed company's next annual meeting at which directors are elected that occurs more than 180 days after the effective date of this listing standard;
- the first anniversary of the effective date of this listing standard; and
- the expiration of the plan.

Nasdaq Rule

The final Nasdaq rule also requires shareholder approval for stock option plans or other equity compensation arrangements, subject to limited exceptions. Like the final NYSE rule, the final Nasdaq rule eliminates the prior exception for broadly-based plans and also eliminates the prior de minimis exception (which allowed for the grant of the lesser of 1% of the number of shares of common stock, 1% of the voting power outstanding or 25,000 shares without shareholder approval).

General Rule. Under the final Nasdaq rule, shareholder approval is required for a stock option or purchase plan that is to be established or materially amended or other equity compensation arrangement made or materially amended pursuant to which options or stock may be acquired by officers, directors, employees, or consultants. Shareholder approval must be obtained prior to the issuance of securities under a stock option or purchase plan or other equity compensation arrangement.

Exemptions. The final Nasdaq rule also contains the following limited exceptions to the general shareholder approval requirement.

- Warrants or Rights Offered Generally to all Shareholders. Warrants or rights issued generally to all security holders of the company or stock purchase plans available on equal terms to all security holders of the company (such as a dividend reinvestment plan);
- Certain Employee Benefit Plans. Tax-qualified, non-discriminatory employee benefit plans (*i.e.*, plans that meet the requirements of Section 401(a) or Section 423 of the Internal Revenue Code) or "parallel nonqualified plans" (which definition generally tracks the definition of "parallel excess plans" under the NYSE rule), provided all such plans are approved by the issuer's compensation committee or a majority of the issuer's independent directors;
- Fair Market Value Purchases. Plans that merely provide a convenient way to purchase shares on the open market or from the issuer at fair market value; or
- Mergers and Acquisitions. Conversion, replacement or adjustment of outstanding options or other equity compensation awards to reflect a merger or acquisition. In addition, shares available under pre-existing shareholder approved plans acquired in acquisitions and mergers may be used for certain post-transaction grants of options and other equity awards by the listed company (after appropriate adjustment of the number of shares to reflect the transaction) either under the pre-existing plan or arrangement or another plan or arrangement, provided:
  - the time during which those shares are available for grants is not extended beyond the period when they would have been available under the pre-existing plan, absent the transaction, and
  - the options and other awards are not granted to individuals who were employed by the granting company or its subsidiaries at the time the merger or acquisition was consummated.

  Like the final NYSE rule, a plan or arrangement adopted in contemplation of the merger or acquisition would not be treated as pre-existing for purposes of this exemption. Any additional shares available for issuance under a plan or arrangement acquired in a connection with a merger or acquisition would be counted by Nasdaq in determining whether the transaction involved the issuance of 20% or more of the company's outstanding common stock and thus required shareholder approval.
- Inducement Awards. Issuances to a person not previously an employee or director of the company, or following a *bona fide* period of non-employment, as an inducement material to the individual's entering into employment with the company, provided such issuances are approved by either the issuer's compensation committee comprised of a majority of independent directors or a majority of the issuer's independent directors. Promptly following an issuance of any employment inducement grant in reliance on this exception, a company must disclose in a press release the material terms of the grant, including the recipient(s) of the grant and the number of shares involved.

  Planning Note: The Nasdaq exemption for inducement awards does not apply to awards to former directors subsequently hired by a company as an employee or to awards to any individual being hired in a non-employee capacity.

Issuers are required to notify Nasdaq no later than 15 calendar days prior to establishing or materially amending a stock option plan, purchase plan or other equity compensation arrangement pursuant to which stock may be acquired by officers, directors, employees, or consultants without shareholder approval.

Planning Note: *Nasdaq is still considering additional rule changes to provide greater transparency to investors, including disclosure to shareholders that the listed company has relied on an exception to the shareholder approval requirement.*

Material Amendments. An Interpretive Material that accompanied the final Nasdaq rule provides the following list of non-exclusive plan amendments that are considered material:

- any material increase in the number of shares to be issued under the plan (other than to reflect a reorganization, stock split, merger, spinoff or similar transaction);
- any material increase in benefits to participants, including any material change to: (i) permit a repricing (or decrease in exercise price) of outstanding options, (ii) reduce the price at which shares or options to purchase shares may be offered, or (iii) extend the duration of a plan;
- any material expansion of the class of participants eligible to participate in the plan; and
- any expansion in the types of options or awards provided under the plan.

While general authority to amend a plan would not obviate the need for shareholder approval, if a plan permits a specific action without further shareholder approval, then no such approval would generally be required provided that the plan is clear and specific enough to provide meaningful shareholder approval of those provisions. However, if a plan contains a formula for automatic increases in the shares available (sometimes called an "evergreen formula"), or for automatic grants pursuant to a dollar-based formula (such as annual grants based on a certain dollar value, or matching contributions based upon the amount of compensation the participant elects to defer), such plans cannot have a term in excess of 10 years unless shareholder approval is obtained every 10 years. However, plans that impose no limit on the number of shares available for grant would require shareholder approval of each grant under the plan. A requirement that grants be made out of treasury shares or repurchased shares will not alleviate these additional shareholder approval requirements.

The Interpretative Material also provides that as a general matter, when preparing plans and presenting them for shareholder approval, issuers should strive to make plan terms easy to understand. In that regard, Nasdaq recommends that plans meant to permit repricing use explicit terminology to make this clear.

Transition Rules. A plan that existed prior to June 30, 2003 is not subject to shareholder approval unless and until it is materially revised.

Conclusion

Listed companies should review their existing stock option and other equity compensation arrangements to determine whether any steps need to be taken. In particular, action may be required with respect to formula or discretionary plans depending upon their terms.

COMPARISON OF CERTAIN PROVISIONS UNDER THE NYSE AND NASDAQ RULES

	NYSE	Nasdaq
Exempt Grants, Plans and Amendments		
Plans made available to shareholders generally	Shareholder approval not required.	Shareholder approval not required.*
Plans that allow employees, directors or other service providers to buy shares at fair market value.	Shareholder approval not required.	Shareholder approval not required.*
Grant of options or other equity-based compensation as a material inducement to a person or persons being hired, or being rehired following a *bona fide* period of interruption of employment	Shareholder approval not required, provided the issuer promptly discloses in a press release the material terms of the award, including the recipient(s) of the award and the number of shares involved.†	Shareholder approval not required.†

	NYSE	Nasdaq
Exempt Grants, Plans and Amendments (cont'd)		
Grants following a corporate merger or acquisition of shares available under pre-existing shareholder-approved plans acquired in the transaction (after adjustment to reflect the transaction) provided (i) the time during which those shares are available is not extended beyond the period when they would have been available under the pre-existing plan, absent the transaction; and (ii) the options and other awards are not granted to individuals who were employed, immediately before the transaction, by the post-transaction listed company or entities that were its subsidiaries immediately before the transaction.	Shareholder approval not required.†	Shareholder approval not required.*
Tax-qualified plans under Sections 401(a) or 423 of the Internal Revenue Code.	Shareholder approval not required.†	Shareholder approval not required.†
Parallel Excess Plans (NYSE) / Parallel Nonqualified Plans (Nasdaq).	Shareholder approval not required.†	Shareholder approval not required.†
Conversion, replacement or adjustment of outstanding stock options to reflect a corporate merger or acquisition.	Shareholder approval not required.†	Shareholder approval not required.*
Material Amendments		
Material increase in the number of shares available under the plan (other than to reflect corporate event).	Shareholder approval required.	Shareholder approval required.
Expansion of the types of awards available under the plan.	Shareholder approval required.	Shareholder approval required.
Material expansion of the class of employees, directors or other service providers eligible to participate in the plan.	Shareholder approval required.	Shareholder approval required.
Material extension of the term of the plan.	Shareholder approval required.	Shareholder approval required.
Material change to the method to determining the strike price of options under the plan (NYSE) / Material change to reduce the price at which shares or options may be offered (Nasdaq).	Shareholder approval required.	Shareholder approval required.
Deletion or limitation of any provision prohibiting repricing of options (NYSE) / Material change to permit a repricing (Nasdaq).	Shareholder approval required.	Shareholder approval required.

† The listed company's independent compensation committee or a majority of the company's independent directors must approve such action and the listed company must notify the NYSE or Nasdaq, as applicable, if shareholder approval is not obtained.

* The listed company must notify Nasdaq if shareholder approval is not obtained.

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