JULY 24, 2003

Shareholder Approval for Equity Compensation Plans

On June 30, 2003, the Securities and Exchange Commission issued an order approving amended proposals by the New York Stock Exchange and Nasdaq Stock Market, Inc., which each expand significantly the need to obtain shareholder approval for the adoption or amendment of equity compensation plans. (Release No. 34-48108 <http://www.sec/gov/rules/sro/34-48108.htm>.) The NYSE standard is also eliminating discretionary voting by broker-dealers in this area by precluding member organizations from giving proxy votes on equity compensation plans without beneficial owner instructions. Nasdaq already has such a provision.

The NYSE and Nasdaq standards will be codified in new section 303A(8) of the NYSE's Listed Company Manual and amended NYSE Rule 452, and in amended NASD Rule 4350(i) and new NASD "Interpretive Manual" IM-4350-5, respectively. These standards take effect immediately for companies that are adopting new plans. Many pre-existing plans are grandfathered but will generally require shareholder approval for amendments. Other pre-existing plans will have to be amended within a specified transition period.

Background

Equity compensation awards to directors and employees can dilute the value and voting power of a publicly-traded company's outstanding securities. Concerns over such shareholder dilution, which underscore the newly-adopted listing standards, have a long history. These concerns came to the public forefront during the high-technology boom of the mid-to-late 1990s, when the popularity of compensatory stock options soared.

Prior to April 1998, NYSE listing standards generally required shareholder approval of any compensation plan that provided stock options or awards to officers, subject to an undefined exemption for "broadly-based" plans covering both officers and other employees. At the urging of listed companies following an amendment to Rule 16b-3 under the Securities Exchange Act of 1934[1], in May 1996, the NYSE submitted a proposal to clarify the "broadly-based" plan exemption. The SEC approved this proposal, but institutional investors protested, claiming that the exemption was too broad.[2] In response, the NYSE convened a task force to revisit the exemption, and in October 1998, proposed to revise the "broadly-based" plan exemption again. This proposal was approved by the SEC in June 1999 on a temporary basis.[3] It is this exemption, which was extended numerous times, that the newly approved NYSE standard replaces.

In November 2000, Arthur Levitt, then-Chairman of the SEC, urged both the NYSE and the Nasdaq to reform their rules and require shareholder approval where shareholders would be diluted to a material degree. Although Nasdaq undertook to

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[1] In 1996, the SEC amended Rule 16b-3, eliminating the required shareholder approval element of the exemption for corporate insiders from the short-swing profit recovery provisions of Section 16(b) of the Exchange Act with respect to stock option plans.

[2] Under the proposal, a plan was deemed "broadly-based," and therefore exempt from shareholder approval, if (1) at least 20% of a company's employees were eligible to participate in the plan, and (2) no more than half of those eligible to participate were officers or directors.

[3] This exemption required a majority of a company's full-time employees to be eligible to receive stock options under the plan (not including hourly wage earners) and required at least a majority of grants under a stock option plan to be awarded to employees other than officers and directors.

address its own "broadly-based" plan exemption, it did not evidence great interest in making the same commitment as the NYSE in this area.[4] The SEC, however, pushed hard to bring the NYSE and Nasdaq together on a standard. So successful was the SEC in this undertaking that the newly approved NYSE and Nasdaq standards are substantively very similar.[5]

What Do the Standards Require?

The standards require listed companies to obtain shareholder approval for new non-exempt equity compensation plans and arrangements as well as for material revisions to these plans and arrangements. There are now special rules for "formula" and "discretionary" plans (see box).

Newly Established Plans

The standards provide that any covered, and not otherwise exempt, plan or arrangement established after June 30, 2003 must be approved by shareholders.

"Material Revisions" to Covered Plans

Any "material revision" of an equity compensation plan or arrangement effected after June 30, 2003 requires shareholder approval under the new standards. Despite specific requests from commenters, neither the NYSE nor the Nasdaq standard specifically defines "material revision"; rather, each provides that the term "material revision"[6] includes the following:

- a material increase in the number of shares available under a 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 a plan;[7]

"Formula" and "Discretionary" Plans

The NYSE standard provides that if a plan contains a formula for automatic increases in the shares available (an "evergreen formula") or for automatic grants under a "formula," *each* such increase or grant will be considered a material revision requiring shareholder approval, unless the plan has a term of not more than ten years. Examples of automatic grants pursuant to a "formula" plan 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 on the amount of compensation he or she elects to defer. The Nasdaq standard is more vague. It merely indicates that "evergreen" and "formula" plans cannot have a term in excess of ten years unless shareholder approval is obtained every ten years.

Under both standards, if a plan contains no limit on the number of shares available (and if, under the NYSE standard, the plan is not a "formula" plan), then *each* grant under the plan will require separate shareholder approval. The NYSE standard refers to this type of plan as "discretionary" and makes clear that this requirement applies regardless of the plan's duration.

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[4] Nasdaq's reluctance in this area reflected predominant concerns of its high-technology listed members that featured stock options heavily in compensation plans.

[5] A few commenters suggested that the SEC urge the American Stock Exchange to propose and adopt listing standards similar to the NYSE and Nasdaq proposals. In response to an SEC request, the AMEX filed a proposed rule change on May 6, 2003, which would require shareholder approval of stock option and equity compensation plans.

[6] The NYSE standard also makes clear that an amendment will not be considered a "material revision" if it curtails rather than expands the scope of a plan.

[7] The standards are silent as to why this provision is not subject to a "materiality" qualifier.

- a material expansion of the class of participants eligible to participate in a plan; and

- a material extension of the term of a plan.

Repricings

Under the NYSE standard, the deletion or limitation of any provision prohibiting "repricing" of options is a material revision and therefore is subject to the shareholder approval requirement. The NYSE standard specifies that a plan that does not specifically *permit* repricing of options will be considered for purposes of this standard as *prohibiting* repricing.[8] Therefore, under such a plan any actual repricing of options would be considered a material revision under the NYSE standard. According to the NYSE standard, "repricing" means any of the following or any other action that has the same effect:

- lowering the strike price of an option after it is granted;

- canceling an option 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, spinoff or other similar transaction; and

- any other action that is treated as a repricing under generally accepted accounting principles.

Further, under the NYSE standard, a material change to the method of determining the strike price of options under a plan constitutes a material revision.[9]

The original Nasdaq proposal did not address repricings, a source of some criticism during the comment process. Nasdaq amended its proposal to reach this issue but treats it in a more cursory manner than the NYSE, simply indicating that a material revision includes any material change to "permit a repricing (or decrease in exercise price) to outstanding options."

What Types of Plans Do the Standards Cover?

The NYSE standard provides that shareholders must be given the opportunity to vote on "all equity compensation plans and material revisions thereto, with limited exceptions." The term "equity compensation plan" is defined as any "plan or other arrangement that provides for the delivery of equity securities . . . of the listed company to any employee, director or other service provider as compensation for services." The NYSE standard also provides that a compensatory grant of options or other equity securities that is not made under a plan will still be treated as an equity compensation plan for shareholder approval purposes. The Nasdaq standard covers "a stock option or purchase plan" or "other equity compensation arrangement" under which "options or

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[8] As one commenter pointed out, this NYSE standard runs contrary to traditional contract construction under which the absence of a prohibition can be construed as permitting repricings under the general authority to modify option terms.

[9] As an example of a non-material revision, the NYSE standard cites a change in the method of determining "fair market value" from the closing price on the date of the grant to the average of the high and low price on that date.

stock may be acquired by officers, directors, employees or consultants." The NYSE standard specifies that plans using treasury shares are subject to the shareholder approval requirement, while the Nasdaq provision indicates that a company is not permitted to use "repurchased" shares to fund option plans or grants without prior shareholder approval.

Under both the NYSE and Nasdaq standards, the following types of plans are not covered:[10]

- plans that are made available to shareholders generally, such as typical dividend reinvestment plans; and

- plans that merely allow participants to buy shares on the open market or from the company at fair market value.[11]

Further, as described below, certain grants and plans are exempted from the shareholder approval requirement.

Exempt Grants

The standards provide exemptions from the shareholder approval requirements for employment inducement awards, awards in mergers and acquisitions, and tax qualified and parallel nonqualified plans. The NYSE standard conditions each of these exemptions on prior approval of the company's independent compensation committee or of a majority of the company's independent directors, and on prior written notification of the NYSE. The Nasdaq standards are similar, except pre-approval is not required for merger or acquisition exemptions. Nasdaq exemptions are subject to Nasdaq's standard 15 calendar day notice obligation (see footnote 10).

Employment Inducement Awards

Both standards exempt from shareholder approval a grant of options or other equity-based compensation as a material inducement to an individual hired by a company or any of its subsidiaries, or re-hired following a bona fide period of interrupted employment. This exemption covers grants to new employees in connection with a merger or acquisition. Under the NYSE standard, promptly following the grant of an inducement award under this exemption, the company must disclose the material terms of the award — including the recipient of the award and the number of shares involved — in a press release. In its approving order, the SEC stated that Nasdaq intends to consider including a disclosure requirement with respect to exemptions from the shareholder approval requirements in this area. Multiple commenters have voiced concerns that this inducement award exemption invites companies to offer large one-time awards of options to incoming executives, so-called "golden handshakes."

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[10] Nasdaq requires notification no later than 15 calendar days prior to establishing (or materially amending) an equity compensation plan or arrangement that does not require shareholder approval.

[11] The NYSE standard specifies that such plans permitting purchase at fair market value do not require shareholder approval, regardless of whether the shares are delivered immediately or on a deferred basis, or whether payments for the shares are made directly or by giving up compensation that is otherwise due (for example, through payroll deductions).

Mergers and Acquisitions

Two exemptions apply in the context of a merger or acquisition:[12]

- Shareholder approval is not required to convert, replace or adjust outstanding options or other equity-compensation awards to reflect the transaction.

- Shareholder approval is not required if the target company has shares available for grant under pre-existing plans that were previously approved by shareholders,[13] and such shares are used for post-transaction grants by the listed company following the transaction, either under the pre-existing plan or another plan, as long as:

  ◊ 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; and

  ◊ the options and other awards are not granted to individuals who were employed, immediately before the transaction, by the acquiring company or entities that were its subsidiaries immediately before the transaction.

Tax Qualified and Parallel Nonqualified Plans

The following types of plans and material revisions to such plans are also exempt from the shareholder approval requirements under both the NYSE and Nasdaq standards:

- plans that meet the requirements under § 401(a) or 423 of the Internal Revenue Code for employee stock ownership and purchase plans, respectively; and[14]

- parallel excess plans (or parallel nonqualified plans), which are "pension plans" within the meaning of ERISA that are designed to provide benefits that exceed certain otherwise applicable Internal Revenue Code limits and work in parallel with plans intended to be qualified under § 401(a) of the Internal Revenue Code.

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[12] The NYSE and Nasdaq require shares reserved for listing with a transaction under these exemptions to be counted in determining whether the transaction involves the issuance of 20% or more of the company's outstanding common stock and therefore to require shareholder approval under the NYSE's Listed Company Manual § 312.03(c) or NASD Rule 4350(i)(1)(C), respectively.

[13] The Nasdaq standard indicates that this exemption applies not only to plans previously approved by shareholders, but also to pre-existing plans that meet the requirements of the newly-approved Nasdaq standard. Both the NYSE and Nasdaq standards indicate that a plan adopted in contemplation of a merger or acquisition would not be considered "pre-existing" for purposes of this exemption.

[14] The NYSE standard also covers equity compensation plans that are "intended to meet" the requirements of § 401(a) or 423 of the Internal Revenue Code. The Nasdaq standard exempts "tax qualified, non-discriminatory employee benefit plans (*e.g.*, plans that meet the requirements of § 401(a) or 423 of the Internal Revenue Code)." This exemption is arguably broader than that of the NYSE standard, which specifically exempts § 401(a) and 423 plans but does not exempt tax qualified employee benefit plans more broadly.

The NYSE standard also exempts equity-compensation plans that provide non-U.S. employees with substantially the same benefits as comparable § 401(a) plans, § 423 plans or parallel excess plans for U.S. employees, except for features necessary to comply with foreign tax law.

Effective Dates and Impact on Pre-Existing Equity Compensation Plans

NYSE Standard

Under the NYSE standard, plans adopted after June 30, 2003 and material revisions to such plans require shareholder approval. Except as provided in the following paragraph, a plan that was adopted before June 30 will not be subject to shareholder approval unless and until it is materially revised.

In the case of (1) "formula" plans that either have not previously been approved by shareholders or that do not have a term of ten years or fewer, and (2) so-called "discretionary plans," whether or not previously approved by shareholders, additional grants may be made after June 30, 2003 without further shareholder approval, but only for a limited transition period.[15] That transition period will end on the first to occur of

- the listed company's next annual meeting at which directors are elected and that occurs after December 27, 2003;
- the first anniversary of the effective date of the NYSE standard; and
- the expiration of the plan.

This transition period was provided in response to numerous comment letters. For example, one commenter pointed out that a transition period is necessary because there is no legal requirement that an equity compensation plan contain a provision that limits its term and many plans have no such provisions.

Under the NYSE standard, however, a company may continue to use a pre-existing shareholder-approved formula plan after the end of this transition period if the plan is amended to provide for a term of ten years or fewer from the later of the date of its original adoption or the date of its most recent shareholder approval. Under the NYSE standard, such an amendment would not itself be considered a "material revision" requiring shareholder approval. Accordingly, it appears from the plain language of the standard that, prior to the end of the transition period, a company may amend its shareholder-approved "formula" plan to establish a term of ten years or fewer without further shareholder approval. In addition, under the NYSE standard, a formula plan may continue to be used, without shareholder

Can a Plan be Separated into "Discretionary" and "Non-Discretionary" Portions?

The NYSE standard provides that a plan can be separated into a discretionary plan portion and a portion that is not discretionary, and the non-discretionary portion of the plan can continue to be used separately. For example, if a shareholder-approved plan permits grants both under a provision that makes available a specific number of shares, and under 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 without further shareholder approval.

[15] Grants under a "discretionary" plan during the transition period must be made in a manner consistent with past practice.

approval, if the grants after the effective date of the NYSE standard are made *only* from the shares available immediately before the effective date.

Nasdaq Standard

The Nasdaq standard also became effective on June 30, 2003, and, subject to the following paragraphs, pre-existing plans are grandfathered. After June 30, new plans (regardless of duration) and material modifications to pre-existing as well as new plans require shareholder approval.

Formula plans must be approved by shareholders every ten years. A company may continue to use a pre-existing shareholder-approved formula plan having a duration of ten years or fewer without further shareholder approval, because such a plan would be grandfathered. A pre-existing plan having a duration of longer than ten years, however, must be approved by shareholders once every ten years — for example, a pre-existing plan that has a duration of longer than ten years, which was last approved by shareholders on June 30, 1998, must be re-approved by shareholders by June 30, 2008 and every ten years thereafter. Further, under the Nasdaq standard, it appears that a pre-existing plan having a duration of longer than ten years can be limited (within a ten-year time frame) to a duration of ten years or fewer from the date of its most recent shareholder approval without further shareholder approval, because the Nasdaq Interpretive Manual does not indicate that it is a material revision to shorten the duration of a plan. While this approach appears to comport with the Nasdaq standard, because the standard does not specifically address this point, a company should contact Nasdaq before taking this approach.[16]

The Nasdaq standard also provides that a plan imposing no limit on the number of shares available for grant (*i.e.* a "discretionary" plan under the NYSE's rubric) requires shareholder approval of each grant under the plan. Because the concern underlying this standard is shareholder dilution, this rule appears to apply to pre-existing "discretionary" plans as well as such plans that are adopted after June 30, 2003 and appears to apply regardless of the duration of the "discretionary" plan. Unlike the NYSE standard, the Nasdaq standard does not contemplate a transition period for "discretionary" plans. Nonetheless, companies that have pre-existing "discretionary" plans should contact the Nasdaq for guidance.

Broker Voting

The SEC also approved an amendment to NYSE Rule 452, which precludes discretionary voting by NYSE member organizations on equity compensation plans, that is, voting (directly or by proxy) without specific voting instructions from beneficial holders. In response to commenters' concerns about the timing of this preclusion, the NYSE implemented a transition period, making this rule effective for any shareholder meeting that occurs on or after September 28, 2003. Notably, NASD rules did not need a similar revision, because those rules currently prohibit discretionary voting by broker-dealers on stock option or purchase plans without explicit instruction from beneficial owners.

Conclusion

With limited exceptions, any new equity compensation plan or material revision to an equity compensation plan will require shareholder approval. The definition of

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[16] If a company has had a formula plan in place for more than ten years prior to June 30, 2003 and that plan has not been approved by shareholders within the past ten years, the company should contact Nasdaq for guidance before making any grant under that plan.

"material" under the standards is quite broad and is subject to interpretive questions. Nonetheless, "material revisions" clearly capture most expansions of the scope of a plan as well as repricings.

In addition, the new standards will cover equity compensation plans of some companies that were in place prior to June 30, 2003 — particularly formula plans having a duration of greater than ten years and discretionary plans. Accordingly, companies should review immediately the terms of such plans under the applicable standard. NYSE-listed companies should promptly assess whether pre-existing formula and discretionary plans must be modified, if not approved by shareholders, before expiration of the specified transition period. Nasdaq-listed companies must determine when shareholder approval is needed for pre-existing formula plans having a duration of greater than ten years and what action must be taken immediately for discretionary plans.

The new standards leave open a number of questions. Listed companies will want to monitor further guidance by the NYSE or Nasdaq. Moreover, given drafting ambiguities and differences in the NYSE and Nasdaq standards, companies may wish to contact the applicable listing body with specific questions regarding transitions under pre-existing plans and other issues.

In sum, the new NYSE and Nasdaq standards respond to concerns over shareholder dilution by broadening significantly the class of equity compensation plans that must be approved by shareholders. This change will take a toll on flexibility in the use of equity as a feature of compensation. Shareholders, however, will likely view this burden as outweighed by the benefits of placing greater accountability on the use of plans that have potentially material dilutive effects.

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