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UPDATE ON NYSE AND NASDAQ SHAREHOLDER APPROVAL REQUIREMENTS

Last week, the New York Stock Exchange and the Nasdaq respectively filed rule changes with the Securities and Exchange Commission regarding shareholder approval requirements applicable to equity compensation plans.[1]

The NYSE filing includes modifications and clarifications to its earlier filing of August 16, 2002. The Nasdaq filing represents a formal request for approval of the rules originally announced as part of its broader corporate governance initiative on May 24, 2002. These filings reconcile many of the differences originally identified between the proposals prepared by each market.

This letter provides a summary of the revisions and clarifications made to the proposed new shareholder approval rules. A full summary of the all of the compensation issues included in both the NYSE and Nasdaq governance proposals is provided in our Alert Letter of September 9, 2002.[2]

NYSE Modifications and Clarifications

The NYSE filing makes the following clarifications and amendments to the proposed shareholder approval requirements applicable to equity compensation plans:

- Basic approval requirement—all equity compensation plans, and any "material" revisions to such arrangements, must be subject to shareholder approval
  - Equity compensation plans are defined to include any plan that is not made available to shareholders generally. As such, the term excludes dividend reinvestment plans and programs that provide "a convenient way (for example, through payroll deductions) for employees, directors, or other service providers to buy shares on the open market or from the issuer, even if the brokerage and other costs of the plan are subsidized"
  - "Material" revisions to equity compensation plans include, but are not limited to any of the following:
    - Increases in the number of shares authorized under the plan, with two exceptions:
      1. Increases that reflect a reorganization, stock split, merger, spin-off, or similar transaction

[1] The NYSE and Nasdaq filings were made on October 7 and 9, respectively.

[2] Refer to http://www.fwcook.com/alert_letters/9-10-02NYSE&NASDAQGoveranceRule....pdf

2. Increases due to an evergreen feature, provided that the automatic replenishment feature is limited to a specified period not to exceed 10 years

-- Changes in the types of awards available under the plan

-- Expansion of the class of participants eligible to receive awards

-- An extension of the term of the plan

-- Material changes in the method of determining the exercise price of stock options granted under the plan. Note that a change in the definition of fair market value (e.g., from closing price to average of high and low price on date of grant) would not be viewed as material

-- The repricing of stock options unless the plan specifically allows for such action

- Repricing clarification—the August 16 filing included a prohibition on repricing of stock options without shareholder approval. The new filing clarifies the following points:

— A plan must "specifically" allow for repricing to enable such an action without shareholder approval. Plans that do not specifically state that repricing is permitted are considered for this purpose as including a prohibition, meaning that a repricing would be considered a material plan revision subject to shareholder approval

— A repricing is defined to include any of the following:

1. Amending the terms of an option after its grant date to lower its exercise price

2. Any action that is treated as a repricing under generally accepted accounting principles

3. Canceling an option at a time when its exercise price is equal to or greater than the fair market value of the underlying stock in exchange for another option, restricted shares or other equity

→ Cancellations and exchanges as described above will be considered a repricing irrespective of whether the option, restricted stock or other equity is delivered simultaneously with cancellation of the underwater option, regardless of whether the exchange is voluntary, and regardless of whether it is considered a repricing under generally accepted accounting principles

→ An exception applies if the cancellation and exchange occurs in connection with a merger, acquisition, spin-off or related corporate transaction

- Treasury stock exception—the filing clarifies that the historic treasury stock exception will no longer be available

- Other exemptions—the following exemptions from the shareholder approval requirements will remain:

  — Employment inducement awards—stock option and other equity incentives made in conjunction with the initial hiring of an employee will be exempt

  — Acquisition awards—shareholder approval will not be required to convert, replace, or adjust outstanding equity awards to reflect mergers or acquisitions. In addition, the shares available under plans acquired in such transactions may be used for post-transaction grants by the continuing entity, under either the pre-existing plan or another plan, as long as two requirements are met: (1) the time period during which the shares are used must not exceed the date the shares would have otherwise become unavailable had there been no transaction, and (2) the shares must be granted to individuals who were employed by the granting company at the time the transaction closed

    -- Note that the NYSE views plans established in contemplation of a transaction as not pre-existing for purposes of the above exemption

- Tax-qualified plans and parallel nonqualified plans—tax-qualified plans, such as those that meet the requirements of IRC section 401(a) and 423, are exempt from the proposed shareholder-approval requirements, as are any parallel nonqualified plans that restore benefits that would otherwise be paid in the absence of IRS limits

  — Parallel plans are defined as those that restore benefits restricted by the limits on pretax employee contribution to 401(k) plans (Section 402(g)), maximum includible compensation (Section 401(a)(17)), and maximum contributions or benefits (Section 415)

  — Nonqualified plans will be considered parallel only to the extent that all employees affected by the Section 401(a)(17) limit (and any additional limits adopted at a later date) are covered under substantially equivalent terms

- Internal approval—under any or all of the circumstances described above when exemptions to the shareholder approval requirement are available, the plans and amendments must be approved by a compensation committee that complies with the NYSE's proposed new requirements[3] or by a majority of the independent members of the board

- Grandfathering of existing plans—plans that are in place as of the effective date of the proposed new rules,[4] but have not been approved by shareholders, will be exempt from the shareholder approval requirements until a material revision is made

  — Note, however, that non-approved plans that contain an evergreen feature must be submitted to shareholders prior to the next formulaic increase in the share reserve that occurs after the effective date of the new rules. For example, if the new rules became effective 1/1/03 and a plan contained a 2% evergreen replenishment feature, the plan would need to be submitted for shareholder approval prior to any automatic replenishments that occur after 1/1/03

Nasdaq Proposed Rules

The Nasdaq initially announced proposed changes to its corporate governance rules on May 24, 2002. With regard to the shareholder approval requirements applicable to equity compensation plans, the initial proposal differed from the NYSE in many regards. The October 9 filing reconciles most of these differences, and in many cases, adopts identical language to that of the NYSE.

The basic shareholder approval requirements, including the types of arrangements covered and specific exemptions (i.e., tax-qualified plans and their parallel nonqualified arrangements, plans relating to a merger or acquisition, and hiring inducements) are identical to the NYSE proposal. In particular, the definition of parallel plan and the permitted exceptions and uses of shares from plans assumed in mergers and acquisitions are identical to the NYSE proposal. The Nasdaq expects that the new rules will become effective immediately upon approval by the SEC and that existing plans as of such date will be grandfathered.

In a distinct divergence from the NYSE, the Nasdaq does not define what constitutes a material amendment to a plan. Rather, it states that it will continue to provide guidance on such issues, taking into consideration a variety of factors (e.g., number of shares and benefits available under a plan, class of eligible participants). As a result, a specific prohibition on repricing is not included.

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[3] The proposed new rules require listed companies to maintain a compensation committee composed solely of independent directors. Independent directors qualify as such only to the extent that they have no "material" relationship with the company directly or as a partner, shareholder or officer of an organization that has a relationship with the company

[4] The effective date of the shareholder-approval requirements is expected to be the date upon which the SEC approves such rules.

Implications

The recent filings indicate that both markets intend to respond aggressively to investor concerns regarding shareholder dilution and related corporate governance issues. The NYSE has clearly taken the lead in this initiative and created pressure for the Nasdaq to adopt substantially similar rules. For the Nasdaq, the new proposal represents a significant shift toward policies that are much more restrictive and protective of shareholder interests than originally anticipated.

Concern among shareholders about the use of equity compensation plans arose several years ago when the NYSE clarified its long-standing definition of "broadly-based" plan. The resulting movement to provide shareholders with a louder voice over dilution of their investment interest has evolved to include specific prohibitions on actions deemed to be "shareholder unfriendly."

Of particular interest to listed companies may be the restriction on repricing under the NYSE proposal. Many companies have historically relied on the absence of prohibitory language in plans as the basis for taking such action. The proposal would appear to clearly prohibit this approach, making virtually all repricings that occur after SEC approval of the proposal subject to a shareholder vote.[5] While the Nasdaq proposal does not include a repricing provision, we anticipate that a similar if not identical posture will be eventually be adopted.

In its description of the factors considered in developing its proposal, the NYSE notes that "one company" suggested that there should be an exemption for situations in which full-value stock is used to deliver an award that otherwise would have been paid in cash. We made this suggestion in recognition of the widespread practice, particularly among financial services companies, of paying a portion of annual bonus in deferred stock. While our specific suggestion was not adopted, it appears that the definition of equity compensation plan may indirectly enable such practices. This is because the NYSE will allow for non-approved arrangements that provide a "convenient way for employees, directors, or other service providers to buy shares on the open market or from the issuer, even if the brokerage and other costs of the plan are subsidized."

Public Comment Period

The rule changes described in this letter will become effective upon approval by the SEC. The SEC has posted the NYSE proposal and is soliciting public comment prior to finalizing the rules.[6] Those interested in submitting comments must do so by October 29. The SEC has not yet posted the Nasdaq proposal.

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This letter is intended to alert compensation professionals about developments that may affect their companies. General questions applicable to exchange-based shareholder approval requirements or the other issues addressed in this letter may be addressed to Daniel Ryterband in our New York office at 212.986.6330 or by email at djryterband@fwcook.com. This letter and other published materials are available on our website, www.fwcook.com.

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[5] The exception would be plans that specifically state that repricing is permitted. In our experience, few plans contain such language.

[6] Refer to http://www.sec.gov/rules/sro/34-46620.htm