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NYSE AND NASDAQ GOVERNANCE RULE PROPOSALS UNDER REVIEW AT SEC

The Securities and Exchange Commission is in the process of reviewing corporate governance proposals approved by the New York Stock Exchange and the Nasdaq Stock Market.

Both proposals have received strong support from virtually all interested parties, including President Bush, SEC Chairman Harvey Pitt, members of Congress, the CEOs of many high profile public companies, institutional investors and state pension funds, and organizations such as the Business Roundtable and the Council of Institutional Investors. As such, the proposals are highly likely to be approved by the SEC.

These proposals address a wide variety of governance issues, many of which involve executive compensation. Most importantly, the proposals address the long disputed rules applicable to shareholder approval of equity compensation plans.[1] This letter provides a summary of the compensation issues and their potential implications.

NYSE Corporate Governance Rule Proposals

The NYSE proposal, which was prepared by the recently formed Corporate Accountability and Listing Standards Committee,[2] was announced on June 6. Following this release, the Exchange solicited public comments and released the details of its final proposal for SEC approval on August 16.

A summary of the compensation-related aspects of the NYSE proposal is provided below:

- Shareholder approval of equity compensation plans—shareholder approval will be required for *all* equity compensation plans, with limited exceptions, and any material revisions to the terms of such plans must also be subject to shareholder approval
  - The exceptions include awards made to new hires, option plans assumed in corporate acquisitions and mergers, and tax-qualified plans such as 401(k) programs and ESOPs (and corresponding nonqualified "excess benefit plans")
    - In instances in which the above exemptions are applied, the grants must be subject to approval of the company's compensation committee (see below for rules applicable to the committee)

[1] Refer to our client Alert letter dated June 12, 2002 (http://www.fwcook.com/alert_letters/6-12-02NYSE&NASDAQAddressCompRel....pdf) for a description of the current shareholder-approval requirements applicable at both exchanges and a history of changes that have occurred to such rules over the past several years.

[2] The Corporate Accountability and Listing Standards Committee is composed of 13 members plus the chairman of the NYSE, who serves in an ex-officio capacity. The Committee was formed following a request from SEC chairman Harvey Pitt on 2/13/02 to review the Exchange's corporate governance listing standards.

- As a result of the above, the historical exemption applicable to grants funded with treasury shares is being eliminated, as is the "broad-based" plan exemption

    - Note, however, that it appears that shares reserved under board-approved plans that exist prior to the effective date would continue to be available for grant without shareholder approval even after the new rules become effective

- With regard to "material revisions to the terms" of equity compensation plans, the Exchange specifically mentions amendments to allow the repricing of existing options as requiring shareholder approval

• <u>Broker votes on equity compensation proposals presented by management</u>—the new rule will prohibit brokers from voting on equity compensation plan proposals unless specific instructions are provided by the shareholder

- The Exchange has historically classified management proposals to increase the share authorization in equity compensation plans as "routine" to the extent the increase did not result in an authorization in excess of 5% of the outstanding common shares. When shareholders fail to vote themselves, brokers have historically been permitted to vote shares held in "street name" on routine proposals, and have almost universally done so in favor of management proposals

• <u>Structure of the compensation committee</u>—listed companies will be required 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

- No director who is a former employee can be considered independent until five years after termination of employment. No other guidelines are provided regarding the materiality of a relationship. Rather, the proposal leaves the determination to the board, but requires that the basis for a determination that a relationship is not material be disclosed in the annual proxy statement

• <u>Compensation committee charter</u>—the committee will be required to have a formal written charter that addresses its purpose, its duties and responsibilities, and a process for evaluating the performance of the committee

- The purpose must include discharging the board's responsibilities related to compensation of executive officers and preparation of the annual committee report for the proxy statement

- Duties and responsibilities must include reviewing and approving corporate goals and objectives applicable to CEO compensation, evaluating the CEO's performance versus these goals, and determining actual CEO payouts based on achievement. It must also include making recommendations to the board regarding incentive plans and equity compensation arrangements

The charter would also be expected to address committee member qualifications, the process for appointing and removing committee members, and the structure and operating procedures of the committee. The charter should also provide the committee with authority to retain its own consultant to assist with director, CEO, and senior executive compensation issues. The committee should have sole authority to retain and terminate the consultant, as well as approve the fees and terms of the engagement.

- Audit committee member compensation—members of the audit committee will be prohibited from receiving any compensation other than director's fees from the company

- Disclosure of corporate governance guidelines—listed companies would be required to disclose certain corporate governance guidelines, which include the compensation committee charter, policies regarding board access to independent advisors, and director compensation guidelines (which should address the process for determining the form and amount of compensation)

  - These governance guidelines must be listed on the company's website and referenced in the annual report

The shareholder approval requirements and the prohibition on brokers voting uninstructed shares will become effective immediately upon SEC approval. The requirement to establish a compensation committee composed solely of independent directors becomes effective 24 months after SEC approval, although at least one independent director must be appointed within 12 months. All other requirements will become effective 6 months after SEC approval.

There are a number of issues in need of clarification, which will hopefully be provided by the SEC or directly by the NYSE. For example, it is not clear whether new hire grants exempted from shareholder approval include restricted shares as well as stock options. It is also not clear whether a second shareholder vote is required to reprice options that were originally granted from a plan that permits repricing, although preliminary guidance we have received indicates that it is not.

Nasdaq Corporate Governance Proposals

The Nasdaq initially announced proposed changes to its corporate governance rules on May 24, 2002. Subsequently, the NYSE proposal was released and the Nasdaq revisited several elements of its original proposal and announced additional modifications on August 21. Some, but not all of the Nasdaq proposals are pending SEC approval.[3] While not identical, the compensation-related aspects are relatively similar to those of the NYSE, as summarized below:

[3] Of the compensation-related Nasdaq reforms, only the independent director proposal has been filed with the SEC for approval.

- Shareholder approval of equity compensation plans—like the NYSE proposal, shareholder approval will be required for *all* equity compensation plans, with limited exceptions, and any changes to the material terms of such plans must also be subject to shareholder approval[4]

  - The Nasdaq proposal allows exemptions for new hire grants, pre-existing grants assumed in a merger or acquisition, and awards made under tax-qualified plans. It also requires that such awards be approved by an independent compensation committee or a majority of a company's independent directors

  - Like the NYSE proposal, existing plans that have not been approved by shareholders will be unaffected, unless a material modification is made

- Independent director approval of executive officer compensation—compensation provided to the CEO and other executive officers will be required to be approved by either an independent compensation committee or a majority of the independent directors

  - Unlike the NYSE proposal, the Nasdaq provides certain guidelines for determining whether a director is independent. Directors will not be considered independent if:

    - They are an executive officer of a charity or not-for-profit organization and the company makes a payment to such organization that exceeds (a) $200,000 or (b) 5% of either the company's or charity's annual revenue

    - They are a former partner or employee of a company's outside auditors

    - They are a relative of an executive officer or own or control 20% or more of the company's voting securities

  In addition to the above, a three-year "cooling off" period will apply to any directors who are not independent by nature of (a) interlocking compensation committees, (b) receipt by the director or a family member of payments in excess of $60,000 other than for board service, or (c) having worked on the company's audit engagement.

  The Nasdaq proposal does not address the compensation committee charter.

- Director compensation—like the NYSE proposal, members of the audit committee will be prohibited from receiving any compensation other than director's fees from the company. Further, independent directors (and their family members) will be prohibited from receiving any payments (including political contributions) in excess of $60,000 other than for board service

[4] Note that the Nasdaq proposal refers to "all stock option plans" rather than all equity-compensation plans, making the requirement somewhat unclear with regard to its applicability to non-option awards (e.g., restricted shares). Our understanding, however, is that the requirement would apply in a manner consistent with that of the NYSE's proposal.

The Nasdaq does not directly address the broker vote issue because broker members of the NYSE are bound by its rules irrespective of whether a proposal is specific to an NYSE-listed or Nasdaq-listed company. For example, as an NYSE member, Merrill Lynch would be prohibited from voting customer shares on a stock plan proposal applicable to Intel (a Nasdaq-listed company) unless specific instructions to do so were provided by the customer.

The Nasdaq proposal includes several elements that appear to be intentionally redundant with those of the Sarbanes-Oxley Act of 2002, including the prohibition of loans to officers and directors and the accelerated reporting requirements of insider stock transactions.[5]

Actions that modify the composition of its board must be taken by the first annual meeting that is at least 120 days after SEC approval of the changes. Presumably, other requirements would become effective immediately upon SEC approval.

Implications

These proposals, whether adopted in their current form or with slight modification, will give shareholders much more control over the level of potential share dilution attributable to equity compensation plans.

There are a number of differences between the NYSE and Nasdaq proposals. Since certain elements of the Nasdaq proposal have yet to be submitted to the SEC for approval, it is possible that additional changes may be made.

We anticipate that the final rules approved by the SEC will be relatively similar in scope, although it is impossible to predict at this time where the compromises will occur. It is also possible that different rules may be approved for each market. Prior to approval, the SEC is expected to provide a public comment period during which interested parties may submit comments and express concerns abut the proposed rules. It is not clear at this point when this comment period will be announced or whether it will apply individually or collectively to the separate proposals prepared by the NYSE and Nasdaq.

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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.

[5] Refer to our client Alert letter dated August 9, 2002 (http://www.fwcook.com/alert_letters/8-9-02SarbanesOxleyActof2002.doc) for a description of the executive compensation implications of the Sarbanes-Oxley Act of 2002.