Frederic W. Cook & Co., Inc.

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SEC APPROVES REVISED NEW YORK STOCK EXCHANGE DEFINITION OF BROADLY-BASED PLAN

On June 4, the Securities and Exchange Commission approved changes to the New York Stock Exchange's shareholder approval policy on stock option and other stock-based award plans. The policy was changed to amend the definition of "broadly-based" plan for purposes of determining whether a plan is exempt from the Exchange's shareholder approval-requirements.

BACKGROUND

The Exchange generally requires that listed companies obtain shareholder approval for stock option, stock purchase, and other plans under which directors and officers may acquire newly listed shares. There are four exemptions from this requirement, one of which is an exemption for plans that are "broadly-based."

Historically, the Exchange's listing requirements have not contained a formal definition of broadly-based plan. Rather, the definition was administered based on a "20% rule of thumb." In December 1997, the Exchange proposed a formal definition requiring at least 20% of employees to be eligible to participate and that no more than 50% of such persons were officers or directors.

This proposal was submitted to the SEC for review, and following a public comment period during which no comments were received, the SEC approved the definition effective April 8, 1998. Shortly thereafter, the Exchange and the SEC received a significant number of inquiries and comments from institutional investors and shareholder activists expressing concern that, in the absence of shareholder approval, companies could inappropriately dilute the value of existing shares.

AMENDED DEFINITION

In response to the criticism of the original definition, the Exchange formed a special task force to solicit public opinion and received 166 comments from various sources. After considering the comments, the Exchange approved subsequent changes to the definition and resubmitted its proposal to the SEC for review on October 1, 1998.

On June 4, 1999, following a public comment period in which 19 comments were received, the SEC approved the revised definition of broadly-based plan, which requires that:

- At least a majority of the issuer's full-time, exempt U.S. employees are eligible to participate under the plan, and
- A majority of the shares awarded under the plan (or shares of stock underlying options awarded under the plan) are made to employees who are not officers or directors

The time frame for measuring whether the above requirements have been met is the shorter of the 3-year period beginning on the date the plan is adopted, or the term of the plan. Officers are defined to include those required to file forms under Section 16 of the Securities Exchange Act of 1934, which includes the company's president, the top finance or accounting officer, and vice presidents or other employees who perform policy making functions or are in charge of business units, divisions, or functions.

The revised definition is an exclusive test, meaning that exceptions are unlikely to be made for companies that fail to meet the test. If is effective on a pilot basis until September 30, 2000, during which time the Exchange plans to address additional concerns expressed by institutional investors.

ONGOING INSTITUTIONAL CONCERN

Despite the tightening of the rules in the revised definition, institutional investors remain concerned about companies' ability to implement stock plans in the absence of shareholder approval. The primary institutional concerns are summarized below:

- The absence of a shareholder-approval requirement permits unlimited dilution, and since officers and directors are not prohibited from participating in broadly-based plans, there is a potential for conflict of interest
- Limiting the eligibility test to full-time, exempt U.S. employees could potentially exclude a large portion of a company's workforce, particularly in heavily unionized companies
- The 3-year measurement period theoretically enables companies to reserve shares in a plan, wait three years, and then make the grants to officers and directors (rather than a broad group of employees) without scrutiny
- There is no proxy disclosure requirement for non-shareholder-approved plans

During the pilot period for the new definition, the Exchange plans to revisit the above concerns and consider whether an aggregate dilution limit should be placed on non-shareholder-approved plans. A new task force has been established to address this issue and the Exchange expects to complete the process in advance of the year 2000 proxy season.

IMPLICATIONS

Despite formal clarification of the broadly-based plan definition, we do not expect a substantial change in the number or design of non-shareholder-approved plans. This is because truly broad-based plans will be unaffected by the change and most companies will continue to seek shareholder approval as part of their overall corporate governance policy.

We do expect interest in non-shareholder-approved plans to continue, however, because the shareholder-approval process can be time consuming, particularly for rapidly growing companies with limited staff resources. In addition, many companies view grants made to non-officers as part of the ordinary process of managing the company. While the revised definition complicates the ability to make non-shareholder-approved grants of newly listed shares, it should be noted that the Exchange’s shareholder-approval requirements do not currently apply to treasury shares, which can be granted without shareholder approval. Unless the Exchange moves to an overall corporate governance approach, as opposed to the current listing requirement, we expect this loophole to continue to be available.

Given the level of institutional concern, it is likely that the Exchange may adopt an aggregate dilution standard applicable to non-shareholder-approved plans. The pilot period provides the Exchange with the necessary time to develop such a standard and the SEC has requested that a proposal be submitted for review by October 15, 1999. This will provide the SEC with sufficient time to review the proposal and solicit public comment prior to the beginning of the year 2000 proxy season.

Whether the dilution standard will apply as a listing requirement or a general corporate governance requirement (initial listing plus treasury shares) is unclear. A complete overhaul of the exemptions from shareholder approval is also possible. Drastic changes, however, seem unlikely unless such measures are universally adopted by other listing organizations (e.g., NASDAQ) or required by the SEC.

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General questions about this letter may be addressed to Daniel Ryterband in our New York office (212-986-6330) or by e-mail at djryterband@fwcook.com. Copies of this letter and other published materials are available on our website, www.fwcook.com.

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