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NYSE RELEASES GUIDANCE ON SHAREHOLDER APPROVAL RULES FOR EQUITY COMPENSATION PLANS

On December 16, 2003, the New York Stock Exchange released guidance on the new shareholder approval rules applicable to equity compensation plans, which became effective on June 30, 2003.[1]

Highlights

The guidance is structured in the form of 27 "frequently asked questions" (FAQs), which address the definition of an equity compensation plan for purposes of the rules, what is considered a material revision, share add-back features and the definition of a "formula plan," and issues related to the use of the various available exemptions.

A summary of the guidance is provided below. The entire text of the FAQs may be viewed on the NYSE's website at www.nyse.com.

Equity Compensation Plans Subject to the New Rules

In addition to typical stock option and equity incentive arrangements, the FAQs clarify that the following arrangements are equity compensation plans that are subject to the new rules:

- Plans that require employee contributions and provide a match in company stock, such as *nonqualified* deferred compensation plans that provide stock-based matching contributions
- Plans that allow employees to purchase shares and provide a cash payment (e.g., 10% of the purchase price) as an inducement to do so
- Plans in which nonemployee members of a company's board of directors receive *non-elective* payments in company stock
- Plans that provide *de minimus* issuances of shares, even if participants are limited to non-officers

[1] Refer to our client alert letter dated 7/1/03, which can be viewed on our website at www.fwcook.com, for a detailed description of the new rules.

As detailed in the original release, certain types of equity compensation plans are exempt, including qualified benefit plans (e.g., 401(k) plans), nonqualified deferred compensation plans that are intended to restore amounts in qualified plans that are limited by IRS restrictions (i.e., "parallel plans"), and plans that allow for *voluntary* deferrals (i.e., the employee could have chosen to take cash) that are credited in company stock. Other exemptions include stock-based awards made to new hires and acquisition awards.

Transition Issues for Existing Plans

The FAQs clarify that an existing plan does not require shareholder approval until a material revision is made, as long as the plan has a fixed number of shares available for grant.

In addition, plans that have a fixed number of shares are neither "formula plans" nor "discretionary plans" simply because they contain a formula for the granting of shares, as long as the shares granted pursuant to the formula count against the maximum share reserve.

Material Revisions

The FAQs clarify that a material revision is anything that has the effect of materially increasing the potential shareholder dilution over the lifetime of the plan. Material revisions include, but are not limited to:

- An expansion of the types of awards permitted under the plan and/or an expansion of the class of eligible participants under the plan
- An increase in the number of shares or an extension of the term of the plan
- A change in the way the strike price of an option is determined
- An increase in the portion of the total share reserve that can be granted as full-value award types (e.g., restricted stock, performance shares)
- Deleting a prohibition on option re-pricing (and presumably, adding a provision to permit re-pricing)

Importantly, if a plan permits certain types of awards but restricts the grant of these awards to specified participants, an amendment to allow such grants to previously ineligible participants would be material. For example, an amendment that enables grants of restricted shares to directors would be material if they were otherwise ineligible to receive such grants, even if the plan permitted grants of restricted stock to other eligible participants.

The new guidance also clarifies that certain amendments are not material, including:

- Amendments to permit awards that are essentially the equivalent of awards already permitted under the plan

- For example, an amendment to permit the grant of restricted stock *units* is not material if the plan already permits restricted stock. Similarly, an amendment to add stock-settled stock appreciation rights would not be material if the plan already permits stock options

- Amendments to *individual* awards (as opposed to plan amendments) that may increase potential dilution, as long as the effect of the revision does not increase dilution beyond the maximum contemplated by the underlying plan

  - For example, if a plan permits options with a 10-year term and an award is issued with a 6-year term, an amendment to increase the term of an outstanding award to 10 years is not material. Similarly, an amendment to increase the post-employment exercise period of an option is not material as long as the amendment does not increase the life of the option beyond the maximum term specified under the plan[2]

- Amendments to the vesting schedule of outstanding awards, since such changes do not increase the maximum potential share dilution under the plan

Formula Plans and Share Counting Rules

Many equity incentive plans include share counting rules that enable add-backs of shares (i.e., net share counting) for certain types of awards. While such provisions are permitted as long as they are contained in the plan, there have been numerous questions about whether the add-back features are considered “formulas” under the NYSE listing requirements.

The guidance clarifies that add-backs attributable to shares that have ***not actually been issued*** do not result in the plan being considered a “formula plan.” Examples of such provisions include add-back of shares attributable to awards that are settled in cash (e.g., options that are cashed-out), awards that expire unexercised or are forfeited, and shares that are held back upon exercise of an option or settlement of an option to cover the exercise price or tax obligations (e.g., constructive stock-for-stock option exercises and stock-for-tax withholding).

Conversely, a provision that permits the add-back of shares ***after they have been issued*** is generally considered a formula. An example of such a provision is a feature that enables the repurchase of shares using the exercise proceeds from option exercises. Other examples include a physical tendering of shares by an employee to pay the option exercise price (as opposed to a constructive exchange) and actual delivery of already owned shares to cover tax obligations.

The new guidance provides important clarification regarding restricted stock. Specifically, an add-back of restricted shares that are forfeited due to failure to meet vesting requirements is not considered a formula feature. However, the withholding of shares to cover taxes upon the vesting of restricted shares is a formula feature, since such awards are considered outstanding immediately upon grant.[3]

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[2] Presumably, if a plan specifies a maximum post-employment exercisability period (e.g., lesser of 3 years or original option term), an amendment to extend the post-employment exercisability beyond this limit would be material.

[3] Presumably, this would not apply to tax withholding on restricted stock *units*, which are not deemed to be outstanding shares at the time of grant.

If a plan includes a formula feature, the term during which the formula may be used must be limited to 10 years from the date of the last shareholder approval.

Rules Related to Exemptions

When a company uses any of the permitted exemptions to the shareholder-approval requirements, the arrangement and/or amendments must be approved by an independent compensation committee or by a majority of the independent members of the board. In addition, companies must notify the NYSE in writing whenever they use any of the exemptions. The new guidance clarifies that the written notice may be provided electronically and must be delivered to the company's listing representative. If not filed before the action, it must be filed as soon as practical.

The new guidance provides important clarification regarding the exemption available for new hire grants:

- When the exemption is used for an award that was individually negotiated, such as that made to an incoming CEO or other senior executive, an immediate press release must be issued
    - Companies that use the exemption for new hire awards that are made automatically (i.e., without individual negotiation) must also issue press releases, although they may be released as infrequently as every two weeks and are permitted to summarize information for all affected new hires
- When the exemption is used for employees of a company acquired through a merger transaction, disclosure of this inducement may be made through a single press release that summarizes awards for all employees, but individual disclosure must be provided for all employees who will be executive officers in the post-merger company
- The new hire exemption is permitted only for employees; it is not available for nonemployee members of the board

The NYSE discourages continued and systematic use of the new hire exemption and encourages companies that intend to make awards upon hire to seek shareholder approval of the plan under which such awards will be made.

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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 and related issues addressed in this letter may be directed 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.