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New York • Chicago • Los Angeles

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NYSE AND NASDAQ ADDRESS COMPENSATION-RELATED CORPORATE GOVERNANCE ISSUES

Over the last several weeks, both the Nasdaq Stock Market and the New York Stock Exchange released comprehensive proposals intended to modify and tighten existing corporate governance standards. These proposals address a variety of governance issues, including several compensation-related items.

Elements of the Nasdaq proposal that apply to compensation are focused on the shareholder approval requirements applicable to stock option and other equity compensation plans in which officers and directors may acquire company stock. The NYSE proposal addresses the shareholder approval issue, along with several other compensation issues.

The Nasdaq proposal was announced on May 24, 2002 following approval by its board of directors, and has been forwarded to the SEC for review and final approval prior to becoming effective.

The NYSE proposal, which was prepared by the recently formed Accountability and Listing Standards Committee,[1] was announced on June 6. The Committee will solicit public comment and then seek approval from the NYSE board at its meeting scheduled for August 1. Assuming the proposal is approved, it would presumably be submitted to the SEC for review prior to becoming effective.

This letter provides a summary of the compensation issues addressed in both the Nasdaq and NYSE proposals.

SHAREHOLDER-APPROVAL OF EQUITY COMPENSATION PLANS

Background and History

With certain exceptions, current rules imposed by both the NYSE and the Nasdaq require shareholder approval of stock option or other arrangements in which officers and directors may acquire company stock.

Both exchanges include exemptions for plans that are "broadly-based" and for grants made to new hires as an inducement to join the organization. NYSE rules also permit grants funded with

[1] The 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.

treasury shares to be made without shareholder approval.[2] Both exchanges generally define a plan to be broadly-based if officers and directors do not receive a majority of the grants.[3]

The use of non-shareholder-approved stock option plans has been one of the most intensely debated corporate governance issues in the last few years. The issue came to the forefront in April 1998 when, following a public comment period during which no comments were received, the SEC approved a formal definition of broadly-based plans adopted by the NYSE. While the broadly-based plan exemption existed before the definition was formalized, the amendment proved to be controversial and was met with immediate criticism from institutional investors and shareholder activists.

In response to this criticism, the NYSE formed a special task force to solicit public opinion, and after considering comments, resubmitted a revised definition to the SEC for approval. On June 4, 1999, the SEC approved the revised definition that is currently in effect.

This current definition was intended to apply during a pilot period originally scheduled to expire on September 30, 2000. During the pilot period, the NYSE developed and submitted a comprehensive proposal for review by the Nasdaq, which if adopted, would have replaced the existing exemptions from shareholder-approval requirements with more stringent standards at the respective markets. The NYSE proposal included the following points:

1. Require shareholder approval of all stock option plans in which officers and directors participate

2. Replace the current shareholder-approval exemption for broadly-based plans with a new standard in which the maximum number of shares available in <u>all</u> such plans is restricted to 10% of the aggregate shares <u>currently</u> available in all shareholder-approved programs maintained by a company

3. Modify the NYSE's historical exclusion of grants funded through treasury shares, so that such shares are subject to the shareholder approval requirements[4]

The Nasdaq solicited public comment on the NYSE proposal and received 239 comments.[5] After review of these comments, the Nasdaq decided against adopting the NYSE proposal, and the NYSE decided that it could not adopt the proposal itself without Nasdaq's agreement.

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2 Note that there is not a specific NYSE exemption applicable to treasury share grants. Rather, the NYSE rules are listing requirements and therefore only apply to newly listed shares. As such, option grants and other equity awards funded with treasury shares have historically been exempt from the shareholder-approval requirement. Note that the Nasdaq does not currently include a specific exclusion for grants funded through treasury shares.

3 Officers are defined to include those required to file forms under Section 16 of the Securities Exchange Act of 1934, which generally include 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.

4 See our letter dated December 14, 2000, (http://www.fwcook.com/121400.html) for a more descriptive summary.

5 A copy of our comment letter dated February 15, 2001, can be viewed on our website (http://www.fwcook.com/021501DJR.html).

Proposed Rule Changes at Nasdaq and NYSE

The Nasdaq and NYSE proposed changes to the shareholder-approval requirements are similar but not identical. A summary follows:

- The Nasdaq proposal would require shareholder approval of <u>all</u> stock option and equity compensation plans and arrangements in which officers and directors may participate
  - The Nasdaq proposal retains the broadly-based plan exemption and the new hire exemption, but requires that grants made to new hires from non-shareholder-approved sources be approved by an independent compensation committee or a majority of a company's independent directors
- The NYSE proposal would require shareholder approval of <u>all</u> equity compensation plans <u>and</u> would prohibit brokers from voting a customer's shares on any equity compensation plan proposal in the absence of specific instructions
  - In its current form, it is not clear whether the NYSE proposal would retain the new hire or broadly-based plan exemptions. These issues will be considered after review of public comments on the proposal, which will be solicited prior to formulating the formal proposal to be submitted to the SEC for approval

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.

We anticipate that the final rules adopted by each market will be relatively similar in scope, although it is impossible to predict at this time where the compromises will occur. As mentioned earlier, the Nasdaq board approved its proposal and the SEC is now reviewing it for approval. The NYSE proposal is in a much earlier stage of development and after review of public comments is likely to be clarified (and perhaps modified) prior to being submitted to the SEC for approval.

<u>OTHER COMPENSATION-RELATED ISSUES PROPOSED AT THE NYSE</u>

In conjunction with the shareholder-approval issue, the NYSE proposal also addresses the following compensation-related items:

- <u>Structure of the compensation committee</u>—listed companies would be required to maintain a compensation committee composed solely of independent directors
  - Note that the definition of independent director would also be tightened
- <u>Compensation committee charter</u>—the committee would 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

  -- 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 would 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. The director compensation guidelines should address the process for determining the form and amount of compensation

Proposed changes to the listing rules would require that companies trading on the NYSE formally adopt governance standards that have historically been only "best practice" recommendations. Given the nature of the proposal and the pressure for reform from the general public and institutional investors, we believe there is a higher likelihood that the proposal will be adopted by the NYSE. Further, we understand that the Nasdaq is also considering possible rule changes that are similar to the NYSE proposal. Therefore, companies should begin reviewing their current practices to determine whether changes are in order.

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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.