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NYSE RELEASES FINAL SHAREHOLDER APPROVAL REQUIREMENTS

The New York Stock Exchange has released its long-awaited final rules regarding shareholder approval requirements applicable to equity compensation plans.

Highlights of Final Rule

The final rules shift the balance of power regarding share dilution away from the Board of Directors in favor of shareholders by confirming several expected changes to existing provisions, including elimination of historic exemptions from the shareholder-approval rules applicable to "broadly-based" plans and the use of Treasury shares, as well as requiring shareholder-approval of all repricings. The final rules also clarify that deferred compensation arrangements and other programs in which participants pay full fair market value for shares do not require shareholder approval. As expected, the final rules grandfather plans already in place as of the effective date, but provide important clarification to the transitional rules for such plans.

Background on the "pilot" program applicable to "broadly-based" plans and earlier versions of the NYSE shareholder-approval rules can be viewed on our website.[1]

SUMMARY OF FINAL RULES

Notification of the final rules was delivered to all NYSE-listed companies via email on June 20, 2003 and became effective when published by the Securities and Exchange Commission in the Federal Register on June 30.

Following publication of the original rule text in October 2002, the NYSE solicited public comments and received 30 letters from the public. In consideration of these comments and ongoing discussion with the SEC, numerous changes to the original proposal have been made.

Shareholder-Approval Requirements

- Basic approval requirement—all "equity compensation plans," and any "material" revisions to such arrangements, must be subject to shareholder approval
  - "Equity compensation plan" is generally defined to include a plan or arrangement that provides for the delivery of equity securities to any employee, director, or other service provider as compensation for services. However, the following

[1] Refer to http://www.fwcook.com/alert_letters/10-15-02UpdateNYSE&NASDAQ....pdf and http://www.fwcook.com/alert_letters/9-10-02NYSE&NASDAQGoveranceRule....pdf

types of arrangements are not considered equity compensation plans, even if the brokerage and other costs of the plan are subsidized by the company:

- Plans that are made available to shareholders in general, such as dividend reinvestment plans
- Plans that allow for the purchase of shares on the open market or through the company at current fair market value, such as deferred compensation arrangements in which employees pay full FMV for deferred shares
- Any plans that pay out in cash, which would include cash-settled phantom stock and deferred share arrangements

— "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
  2. Increases under a "formula plan," provided that the term of the plan is not more than 10 years[2]
     → "Formula plans" include those with an evergreen feature (i.e., automatic replenishment of shares) or a plan in which grants occur automatically under a specified formula (e.g., director plans in which a specified number of shares are granted annually)
- An expansion 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

[2] See section entitled "Effective Date and Transition Rules" for information applicable to "formula plans" that do not have a term of less than 10 years.

- Repricings—any plan that does not contain a provision that *specifically* permits repricing is deemed to be one that prohibits such action and therefore requires shareholder approval

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

    1. Lowering the exercise price of an option after it is granted

    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

       → 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 final rule clarifies that the historic treasury stock exception is no longer available. However, use of treasury stock should still be permissible for arrangements in which shareholder-approval is not required (e.g., new hires, deferral programs)

- Other exemptions—the following exemptions from the shareholder approval requirements are available:

  — Employment inducement awards—stock option and other equity incentives made in conjunction with the initial hiring (or rehire following a bona fide interruption of service) of an employee are exempt. This exemption also applies to grants made to new employees in connection with mergers and acquisitions

    -- Promptly following the grant of an inducement award, the company must disclose in a press release its material terms, including the recipients and the number of shares

  — Acquisition awards—shareholder approval is not 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 four requirements are met: (1) the pre-existing plan was approved by shareholders, (2) the number of shares available for grant is appropriately adjusted to reflect the transaction, (3) 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 (4) the shares are not granted to individuals who were, immediately before the transaction, employees of the acquiring company or its subsidiaries

-- Plans that are adopted in contemplation of a transaction are not viewed as 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[3]

-- 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, and only if the maximum employer contribution is limited to 25% of participants' cash compensation

- 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 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

Broker Voting Rules

The final rules prohibit member organizations (i.e., brokers) from giving a proxy to vote on equity compensation plans unless specific instructions to do so have been given by the owner of the shares.

Historically, the broker vote resulted in shares held in "street name" that were not voted by their owners to be considered as positive votes in favor of management stock plan proposals (assuming that such proposals were deemed to be "routine"). The exclusion of such shares will create additional complexity in securing shareholder approval by providing more power to institutional investors.

EFFECTIVE DATE AND TRANSITION RULES

The shareholder approval requirements generally become effective on June 30, 2003 and the broker vote restriction becomes effective 90 days thereafter (i.e., 9/23/03). For purposes of the prohibition on repricing, any exchange offer that commenced prior to the effective date of the new rules is exempt from the shareholder approval requirement.

[3] Note that plans that provide foreign employees with essentially the same benefits available to US employees under a tax-qualified or parallel excess plan are also exempted.

"Formula plans," as defined earlier, which have been shareholder-approved and have a term of less than 10 years may continue to be used without need for additional shareholder approval until expiration of the plan. If the plan does not have a term of 10 years or less, it must be amended to have a term no greater than 10 years from the later of the its original adoption or most recent shareholder approval.[4]

Plans that are in place as of June 30, 2003 that have <u>not</u> been shareholder approved are generally exempt from the shareholder approval requirements set forth above until a material revision to the arrangement is made, unless the arrangement is deemed to be a "discretionary plan" or a "formula plan," in which case a limited transition period applies.

A "discretionary plan" is one that has <u>no</u> limit on the number of shares available for grant and is not a "formula plan." Exemption from the shareholder approval requirements is available for non-approved "discretionary plans" and "formula plans" only until the earliest of expiration of the plan, the company's next annual meeting occurring after 12/27/03 (i.e., 180 days after the effective date of the new rules), or 6/30/04 (i.e., the first anniversary of the effective date of the new rules).

IMPLICATIONS

The final rules address long-standing shareholder concerns applicable to share dilution from non-approved plans and the repricing of outstanding stock options. The net effect is a significant shift in the balance of power away from the Board of Directors to shareholders, especially when considering the impact of the broker vote prohibition.

The new rules raise the importance of carefully managing aggregate share usage and potential dilution levels. They also increase the importance of certain equity plan design features (e.g., share counting rules, maximum aggregate award limits, etc.) and the provisions of individual stock option awards (e.g., option terms, post-employment exercisability, etc.), which can result in significant amounts of potential dilution being allocated to employees who no longer provide services.

The importance of effective shareholder communications will also rise as a result of the new rules, especially for companies with severely depressed share prices, high levels of potential dilution, or other organizational challenges affecting equity incentives.

Of particular significance is the elimination of the historic exemption applicable to "broadly based" plans and the use of treasury shares, which essentially enabled companies to grant awards without shareholder approval on an unchecked basis. While the new rules severely restrict companies, they do maintain certain flexibilities that have historically been viewed as reasonable by shareholders and important by companies, such as the new hire exemption and the ability to credit deferrals in shares.

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[4] Note that if the required amendment is not made, the plan will become subject to the limited transition period applicable to non-approved formula plans and discretionary plans.

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.