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**Nasdaq Stock Market Requests Public
Comments on Shareholder Approval Issues**

Under current rules, both the New York Stock Exchange (NYSE) and the Nasdaq Stock Market allow an exemption from shareholder approval for stock option plans that are deemed to be “broadly-based.”

On December 5, the Nasdaq released a bulletin requesting public comments on marketplace requirements for shareholder approval of stock option plans. Comments are due no later than January 5, 2001.

The request follows recent remarks by SEC Chairman Arthur Levitt that increased use of nonshareholder-approved plans must not be tolerated. Mr. Levitt suggested that the SEC will take action if the financial markets do not.

BACKGROUND

Both the NYSE and the Nasdaq have long exempted broadly-based plans from shareholder approval requirements. This position was based on the assumption that preferential treatment to officers and directors would be mitigated if a broad group of employees participated in the same plan.

The use of nonshareholder-approved stock option plans has been one of the most intensely debated corporate governance issues in the last few years. On one side are the institutional investors and shareholder activists who generally believe that shareholder approval should be required for all stock compensation programs to avoid inappropriate dilution of outstanding shares. On the other side are the listed companies, some of whom believe that the granting of stock options without shareholder approval is justified under certain circumstances.

The issue came to the forefront in April of 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.¹ 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

¹ The formal definition was adopted to clarify what constituted a broadly-based plan. The Nasdaq does not have a formal written definition, but a plan is generally deemed to be broadly-based if (1) the majority of participants are not officers or directors and (2) officers and directors do not receive a majority of the grants.

comments, resubmitted a revised definition to the SEC for approval. On June 4, 1999, the SEC approved the revised definition, effective on a pilot basis until September 30, 2000.²

The SEC requested that the NYSE work closely with the Nasdaq to develop mutually acceptable shareholder approval requirements during the pilot period. The markets have not yet reached a consensus proposal and the pilot period for the revised NYSE definition of broadly-based has expired.³

NEW YORK STOCK EXCHANGE PROPOSAL

During the pilot period, the NYSE developed and submitted for review by the Nasdaq a comprehensive proposal, which if adopted, would replace the existing exemptions for broadly-based plans with much more strict standards at the respective markets. If adopted, the NYSE proposal would:

1. Require shareholder approval of all stock option plans in which officers and directors participate
 - Exceptions would be available for tax-qualified plans, option grants made to new hires, and options granted (or assumed) in connection with merger and acquisition transactions
 - For purposes of determining who is an officer, the rule would require using the definition under Section 16 of the Securities Exchange Act of 1934
2. Replace the current shareholder approval exemption for broadly-based plans (i.e., those covering employees other than officers and directors) with a new standard in which the maximum number of shares available in all such plans is restricted to 10% of the aggregate shares currently available in all shareholder-approved programs maintained by a company
 - For purposes of determining the 10% limit, companies would count only outstanding options (i.e., unexercised and unexpired) and shares reserved for future grant as of the date the nonshareholder-approved plan is adopted or grant is made
 - Shares approved in the original share authorization that have been exercised or expired do not count for purposes of determining the 10% limit

² See our alert letters dated June 14, 1999 and October 22, 1998. The revised NYSE definition of broadly-based plan generally requires that at least a majority of an issuer's full-time, exempt staff are eligible to participate, and a majority of the shares awarded under the plan are granted to employees who are not officers or directors.

³ The NYSE has requested and is awaiting approval from the SEC for a temporary extension.

- Shares granted through tax-qualified plans would be excluded from the 10% limit, but nonshareholder-approved grants made to new hires and in conjunction with a merger or acquisition would count against the limit
3. Modify the NYSE’s historical exclusion of grants funded through treasury shares,⁴ rather than newly issued shares, so that such shares are subject to the shareholder approval requirements
- An exception would apply for shares repurchased by the company if such shares continue to be treated as outstanding for purposes of dividend payments and voting rights
 - The use of repurchased shares would be subject to approval by a majority of independent directors (or a committee consisting solely of independent directors) and must be approved by shareholders within two years of the date the plan is adopted
 - If the plan has a term greater than five years, it must be reapproved by shareholders within the first two years after the expiration of each five-year term
 - In the event that shareholders disapprove of the plan, it will have no effect on awards granted under the plan or upon use of the shares repurchased for use in the plan prior to the vote

POSSIBLE DISCLOSURE CHANGES

In addition to the shareholder approval modifications, the NYSE is also recommending to the SEC that revisions be made to proxy statement disclosure requirements contained in Regulation S-K. The changes are intended to provide shareholders and analysts with all of the information needed to conduct their own dilution calculations. These changes would amend the Option/SAR Grants Table to include:

- Annual share grant data and weighted average exercise price for all employees in aggregate (i.e., in addition to the current required CEO and four other named executive officers)
- Total outstanding awards and weighted average exercise price held by all employees as of the end of the most recently completed fiscal year
- Total shares available for grant as of the end of the latest fiscal year, plus the number of total shares issued and outstanding

⁴ The NYSE shareholder approval rules are listing requirements that apply to the use of newly listed shares. As such, option grants funded with treasury shares have historically been exempt from the shareholder-approval requirement. Note that the Nasdaq does not include a specific exclusion for grants funded through treasury shares.

The proposal also includes similar changes to the Long-Term Incentive Plans Award Table with regard to restricted and unrestricted stock awards. It also recommends detailed proxy statement disclosure on all plans in which options, restricted stock, and similar awards can be granted, including the name of the plan, whether it is shareholder-approved, the aggregate amount of awards issued and outstanding, and whether the plan permits repricing.

IMPLICATIONS

SEC Chairman Levitt has asked the Nasdaq to adopt the NYSE proposal with regard to both (1) the shareholder-approval requirement for all plans in which officers and directors participate, and (2) the maximum dilution cap on nonshareholder-approved plans. Before responding to the SEC, however, the Nasdaq will consider comments from all constituencies, which include shareholders, listed companies, and other affected parties.

Based on Mr. Levitt's comments, it appears that the SEC is moving quickly on this issue. It seems likely that the approach eventually approved by the SEC will limit dilution attributable to nonshareholder-approved plans and preclude companies from using such plans to make option grants to officers and directors. Related changes to proxy statement disclosure rules, if adopted by the SEC, would also result in shareholders receiving more detailed and easy to interpret data on stock option and other equity plans.

The net result of the NYSE shareholder-approval proposal, if adopted, would be to provide shareholders with a stronger voice in option plans and raise the level of accountability among the officers and directors who administer them. While the proposal would restrict nonshareholder-approved dilution to approximately 10% of the approved level, it would continue to provide management with flexibility to make nonshareholder-approved grants to the rank-and-file. However, the 10% limit could create difficulties for distressed companies that need to quickly grant stock option awards to stem the loss of talent if share prices fall and outstanding stock options lose their retentive power.

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Copies of the Nasdaq bulletin and the NYSE proposal, as well as contact information for submitting comments to the Nasdaq, can be obtained from the Nasdaq's website at <http://secure.nasdr.com>.

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