

Client Alert

NYSE and Nasdaq Adopt Final Rules on Shareholder Approval of Equity Compensation Plans and Broker Voting

A. Introduction

The final New York Stock Exchange and Nasdaq corporate governance rules relating to shareholder approval of equity compensation plans and the voting of proxies were approved by the Securities and Exchange Commission and became effective as of June 30, 2003, subject to certain transition periods.¹ The final rules generally require that all equity compensation plans, and any material revisions to the terms of such plans, be made subject to shareholder approval, with certain limited exceptions. The NYSE rules also preclude brokers from voting shares on equity compensation plan proposals presented at shareholder meetings that occur on or after September 28, 2003 without instructions from beneficial owners. The final rules modify in several respects the rules originally proposed by the NYSE and Nasdaq in October 2002.

B. Shareholder Approval of Equity Compensation Plans

Under the NYSE and Nasdaq rules, with certain exceptions, all equity compensation plans, as well as “material revisions” to the terms of such plans, must be approved by the issuer’s shareholders. Even a single compensatory grant of options or other equity securities that is not made under a formal plan is deemed an “equity compensation plan”.

Under the NYSE rules, “equity compensation plans” do not include:

- plans that are made available to shareholders generally, such as dividend reinvestment plans; or

¹ Securities and Exchange Commission Release No. 34-48108; File Nos. SR-NYSE-2002-46 and SR-NASD-2002-140. A copy of the Release is available on the SEC website at <http://www.sec.gov/rules/sro/34-48108.htm>.

The American Stock Exchange has also proposed rules relating to shareholder approval of equity compensation plans, but these rules are not yet effective.

- plans that merely allow participants to purchase company shares at their current fair market value.

Nasdaq also exempts these two types of plans.

In addition, under both the NYSE and Nasdaq rules, the following equity compensation plans are specifically exempt from the shareholder approval requirement:

- employment inducement awards (*i.e.*, grants of options or equity-based compensation that serve as a material inducement to a person being hired or being rehired following a bona fide period of interruption of employment);
- plans relating to mergers or acquisitions (*e.g.*, adjustments to outstanding equity compensation awards and certain plans assumed in an M&A transaction);² and
- tax qualified plans (*e.g.*, savings plans and employee stock purchase plans)³ and parallel excess plans.⁴

Under the NYSE rules, any equity compensation plan that is not subject to shareholder approval must be approved by the company's independent compensation committee or a majority of independent directors. Companies must also notify the NYSE in writing when they use one of the exemptions from the shareholder approval requirements. The NYSE rules also require companies to provide prompt public disclosure following the grant of an inducement award made in reliance on the exemption.

Under the Nasdaq rules, any employment inducement award, tax qualified plan or parallel excess plan that is not subject to shareholder approval must be approved by the company's compensation committee or a majority of independent directors. The Nasdaq rules require notification to Nasdaq at least 15 days prior to establishing or materially amending any equity compensation plan without shareholder approval.

² The exemption for plans acquired in a merger or acquisition is subject to certain conditions and restrictions.

³ Under the NYSE rules, this exemption also covers equity compensation plans for non-U.S. employees with substantially the same benefits as comparable tax-qualified plans provided to U.S. employees.

⁴ Under the NYSE and Nasdaq rules, a plan must meet certain requirements to be considered a parallel excess plan (*e.g.*, no participant may receive employer equity contributions under the plan in excess of 25% of the participant's cash compensation).

The new rules effectively eliminate the following prior exceptions to shareholder approval requirements for equity compensation plans:

- the NYSE treasury stock exception (which allowed for the use of equity compensation plans using only treasury shares without obtaining shareholder approval);
- the Nasdaq *de minimis* exception (which allowed for the use of equity compensation plans involving a *de minimis* number of shares without obtaining shareholder approval); and
- the NYSE and Nasdaq “broadly-based” plan exception (which allowed for the use of certain plans available generally to a large number of employees without obtaining shareholder approval).

Material revisions. Material revisions to equity compensation plans must also be approved by shareholders. Some examples of “material revisions” are revisions that:

- materially increase the number of shares available under the plan (other than increases solely to reflect a reorganization, stock split, merger, spin-off or similar transaction);
- expand the types of awards available under the plan;
- materially expand the class of persons eligible to participate in the plan;
- materially extend the term of the plan; or
- materially change the method of determining the strike price of options under the plan.

The NYSE rules state that a change in the method of determining “fair market value” from the closing price on the date of grant to the average price on the date of grant would not be deemed a material revision.

Formula plans. If a plan contains a formula for automatic increases in the shares available (*i.e.*, an “evergreen formula”) or provides for automatic grants pursuant to a formula (such as annual grants to directors of restricted stock having a certain dollar value), each increase or grant under any such “formula plan” will be considered a revision requiring shareholder approval unless the term of the plan is ten years or less.

Discretionary plans. If a plan contains no limit on the number of shares available and is not a “formula plan”, the rules require each grant under any such “discretionary plan” to be separately approved by shareholders, whether or not the plan’s term is ten years or less.

Repricing. The NYSE rules provide that, if a plan prohibits repricing of options, any revision that deletes or limits the scope of that provision will be deemed a material revision. If a plan does not specifically permit repricings of options, the plan will be deemed to prohibit them and any actual repricing of options will be considered a material revision to the terms of the plan, even if the plan itself is not revised.⁵ The Nasdaq rules provide that a revision to permit a repricing of outstanding options will be deemed a material revision. Nasdaq also recommends that plans meant to permit repricing use explicit language to make this clear.

Transition rules. Except as described below, any existing equity compensation plan in place before June 30, 2003 will not be subject to the new NYSE or Nasdaq shareholder approval requirements unless there is a material revision to the plan.

The NYSE rules provide that, in the case of discretionary plans adopted before June 30, 2003, whether or not previously approved by shareholders, additional grants may be made after June 30 without shareholder approval only for a limited transition period (described below) and in a manner consistent with past practice.⁶

Similarly, the NYSE rules provide that, in the case of formula plans adopted before June 30, 2003 that either (1) have not previously been approved by shareholders or (2) do not have a term of ten years or less, additional grants may be made after June 30 without further shareholder approval only for a limited transition period. A company may continue to use a shareholder-approved formula plan after the end of this transition period if the plan is amended to provide for a term of ten years or less. In addition, a company may continue to use a formula plan after the transition period without shareholder approval if grants are made only from shares available

⁵ For these purposes, a “repricing” means: (i) lowering the strike price of an option after it is granted, (ii) any other action treated as a repricing under GAAP or (iii) canceling an option at a time when its strike price exceeds the fair market value of the underlying stock, in exchange for another option, restricted stock, or other equity, unless the cancellation and exchange occur in connection with a merger, acquisition, spin-off or similar transaction.

⁶ Under the rules, if a plan can be separated into a discretionary portion and a non-discretionary portion, the non-discretionary portion can continue to be used separately.

immediately before June 30, 2003 (*i.e.* based on formula increases that occurred prior to June 30).

The transition period under the NYSE rules for continued grants under discretionary plans and formula plans will end at the first to occur of (1) the issuer's next annual meeting that occurs after December 27, 2003, (2) June 30, 2004 and (3) expiration of the plan.

The Nasdaq rules do not provide for similar transition periods.

C. Voting of Proxies

The NYSE rules preclude brokers from voting shares on equity compensation plan proposals presented at shareholder meetings that occur on or after September 28, 2003 without instructions from beneficial owners. The new rules apply to NYSE-member brokers and, as such, will affect all public companies and may require significantly greater efforts in the solicitation of shareholder votes on equity compensation plans. The NYSE intends to establish a working group to advise on possible mechanisms to facilitate implementation of this new requirement.

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For Additional Information

This client alert can be found, together with other recent Chadbourne & Parke LLP client alerts, at http://www.chadbourne.com/publications/sub_Publications.html. If you have any questions regarding the new NYSE and Nasdaq rules on equity compensation plans, please contact any of the following:

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