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SEC Approves NYSE and NASDAQ Proposals for Shareholder Approval of Equity Compensation Plans

On June 30, 2003, the Securities and Exchange Commission issued an order approving rule changes proposed by the New York Stock Exchange and Nasdaq that require shareholder approval of equity compensation plans. At the same time, the SEC ordered the approval on an accelerated basis of amendments to these proposed rule changes. As a result of the order, the NYSE adopted new Section 303A(8) to its Listed Company Manual, replacing its current pilot program with respect to the definition of a "broadly-based" stock option plan, and amended Rule 452 regarding broker voting of shares for approval of equity compensation plans. Nasdaq amended NASD Rule 4350(i) and adopted "Interpretive Material" pertaining to the amended rule. These changes became effective immediately upon SEC approval.

This memorandum summarizes the principal provisions of the NYSE and Nasdaq proposals as amended and approved by the SEC and subsequently adopted by the NYSE and Nasdaq.

I. NYSE Rule Changes

Section 303A(8) of the NYSE's Listing Company Manual has become effective as a result of SEC approval. Section 303A(8) requires shareholder approval of all equity compensation plans and material revisions to such plans, subject to limited exemptions. An equity compensation plan is defined as a plan or other arrangement that provides for the delivery of equity securities (either newly issued or treasury shares) of the listed company to any employee, director or other service provider as compensation for services, including a compensatory grant of options or other equity securities that is not made under a plan.

A. Exclusions

Plans that are made available to shareholders generally and deferred compensation plans under which employees pay full current market value for deferred shares are specifically excluded from the rule's definition of "equity compensation plans," even if the company pays for employees' brokerage and other costs.

Prior exemptions for plans that delivered treasury shares and for "broad based" plans have been eliminated.

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B. Exemptions

New Section 303A(8) exempts several types of plans from the shareholder approval requirement. These exemptions include:

- inducement awards to persons becoming employees of the issuer or any of its subsidiaries for the first time;[1]
- conversions, replacements or adjustments of outstanding options or other equity compensation awards necessary to reflect mergers or acquisition transactions;
- shares available under certain plans acquired in corporate acquisitions and mergers, which may be used for certain post-transaction grants without further shareholder approval;[2] and
- tax qualified and parallel excess plans.[3]

Shares reserved for listing in connection with a transaction pursuant to either of the exemptions related to mergers and acquisitions described above will be counted by the NYSE in determining whether the transaction involves the issuance of 20% or more of the company's outstanding common stock and therefore requires shareholder approval under Listed Company Manual Section 312.03(c).

When equity compensation plans and amendments to plans are not subject to shareholder approval, such plans and amendments must be subject to the approval of the company's

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[1] In addition to the approval and disclosure rules discussed below, companies are required to disclose in a press release the material terms, including the recipient and number of shares involved, of any inducement award granted under this exemption.

[2] This exemption is available where a party that is not a listed company following the transaction has shares available for grant under pre-existing plans that were previously approved by shareholders, provided that (i) the number of shares available for grant is appropriately adjusted to reflect the transaction; (ii) the time during which those shares are available is not extended beyond the period when they would have been available under the pre-existing plan; and (iii) the options and other awards are not granted to individuals who were employed, immediately before the transaction, by the post-transaction listed company or entities that were its subsidiaries immediately before the transaction. A plan adopted in contemplation of the merger or acquisition transaction would not be considered "pre-existing" for the purposes of this exemption.

[3] Tax qualified plans are those that meet the requirements of Section 401(a) or Section 423 of the Internal Revenue Code (including compliant employee stock purchase plans). A "parallel excess plan" is a plan that qualifies as a "pension plan" within the meaning of ERISA, designed to work in parallel with a tax qualified plan to provide benefits that exceed the limits of such tax qualified plans.

compensation committee or a majority of the company's independent directors. Companies must also notify the NYSE in writing when they use one of the exemptions described above.

C. Material Revisions

Section 303A(8) provides a non-exclusive list of "material revisions" to a plan that would require shareholder approval. The list includes:

- A material increase in the number of shares available under the plan (other than an increase solely to reflect a reorganization, stock split, merger, spinoff or similar transaction).
    - If a plan contains a formula for automatic increases in the shares available (sometimes called an "evergreen formula") or for automatic grants pursuant to a formula, [4] it will be considered a "formula plan" and each such increase or grant will be considered a revision requiring shareholder approval *unless* the plan has a term of not more than ten years.
    - If a plan contains no limit on the number of shares available and is not a formula plan, then it is considered a "discretionary plan" and each grant under the plan will require separate shareholder approval *regardless* of the term of the plan.[5]
- An expansion of the types of awards available under the plan.
- A material expansion of the class of employees, directors or other service providers eligible to participate in the plan.
- A material extension of the term of the plan.
- A material change to the method of determining the strike price of options under the plan.[6]

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[4] Examples of automatic grants pursuant to a formula are (1) annual grants to directors of restricted stock having a certain dollar value, and (2) "matching contributions," whereby stock is credited to a participant's account based upon the amount of compensation the participant elects to defer.

[5] A requirement that grants be made out of treasury shares or repurchased shares will not, in itself, be considered a limit or pre-established formula so as to prevent a plan from being considered a discretionary plan.

[6] A change in the method of determining "fair market value" from the closing price on the date of grant to the average of the high and low price on the date of grant is an example of a change that the NYSE would not view as material.

- The deletion or limitation of any provision prohibiting repricing of options.

An amendment that curtails, rather than expands, the scope of the plan in question, will not be considered a "material revision."

D. Repricing

Under Section 303A(8), equity compensation plans that do not contain a provision specifically *permitting* repricing of options will be considered as *prohibiting* repricing. Accordingly, any actual repricing of options will be considered a material revision of a plan even if the plan itself is not revised, although this provision does not apply to repricings through exchange offers that commenced before the listing standard becomes effective. "Repricing" is defined as any of the following actions, or any other action that has the same effect:

- Lowering the strike price of an option after it is granted.
- Any other action that is treated as a repricing under GAAP.
- 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 occurs in connection with a merger, acquisition, spin-off or other corporate transaction.

E. Transition Rules

An equity compensation plan that was in place before the NYSE proposal was approved will not be subject to shareholder approval unless such plan is "materially revised."

Shareholder approval will be required, however, for each grant issued under a pre-existing discretionary plan and for additional grants made under pre-existing formula plans not previously approved by shareholders that do not have a term of ten years or less after the expiration of a limited transition period. (See "Material Revisions" above.) This transition period will expire at the earliest of:

- the company's first next annual meeting at which directors are elected that occurs more than 180 days after June 30, 2003;
- June 30, 2004; and
- the expiration of the plan.

Additional grants may be made under per-existing discretionary plans without shareholder approval before the expiration of the transition period, but only in a manner consistent with past practice. Similarly, additional grants may be made under pre-existing, non-shareholder approved formula plans that do not have a term of ten years or less without shareholder approval before the transition period expires. After the end of the transition period, a formula plan that has not been

approved by shareholders may continue to be used if grants are made only from the shares available immediately before June 30, 2003 (i.e., based on formulaic increases that occurred prior to June 30, 2003).

Shareholder-approved formula plans may continue to be used after the end of the transition period if they are amended to provide for a term of ten years or less from the date of their original adoption or, if later, the date of their most recent shareholder approval. Such an amendment would not be considered a "material revision" requiring shareholder approval.

F. Broker Voting (Rule 452)

As a result of the SEC's approval, the NYSE also adopted Rule 452, which prohibits member organizations from voting on equity compensation plans unless the beneficial owner of the shares has given voting instructions. This rule will apply only to shareholder meetings that occur on or after the 90th day following June 30, 2003.

G. Foreign Issuers

The NYSE has stated that it will continue to exempt foreign private issuers from its corporate governance standards if those issuers provide or have provided written certification from independent counsel in their home-country stating that the company's governance practices comply with home country-law and the rules of the company's principal securities market outside the United States. It should be noted that under proposed changes to the Listed Company Manual, listed foreign private issuers that do not comply with the NYSE rules will be required to disclose the ways in which their corporate governance practices differ significantly from the NYSE standards.

II. Nasdaq Rule Changes

Nasdaq's proposed NASD Rule 4350(i)(1)(A) and new "Interpretive Material" IM-4320-5 were implemented following the SEC's approval. The new rule and accompanying interpretive material require shareholder approval for the establishment or material amendment of stock option plans or equity compensation arrangements, subject to certain enumerated exceptions. In addition, pursuant to conforming changes made to NASD Rules 4310(c)(17)(A) and 4320(e)(15)(A), Nasdaq now requires issuers to notify Nasdaq, on the appropriate form, that the issuer intends to establish or materially amend a stock option plan, purchase plan or other equity compensation arrangement pursuant to which stock may be acquired by officers, directors, employees or consultants without shareholder approval 15 days before any such plan is established or amended.

The SEC order notes that Nasdaq has represented to the SEC that its staff intends to consider further changes to provide greater transparency to investors. One rule change under consideration is a requirement for issuers to disclose reliance on exceptions to NASD Rule 4350(i)(1)(A) to the rules requiring shareholder approval.

A. Material Amendments

The interpretive material that accompanies the new rule provides a non-exclusive list of "material amendments" to a plan that would require shareholder approval. The list includes:

- any material increase in the number of shares to be issued under a plan (other than to reflect a reorganization, stock split, merger, spinoff or similar transaction);
- any material increase in benefits to participants, including any material change to: (i) permit a repricing (or decrease in exercise price) of outstanding options, (ii) reduce the price at which shares or options to purchase shares may be offered, or (iii) extend the duration of a plan;
- any material expansion of the class of participants eligible to participate in the plan; and
- any expansion in the types of options or awards provided under the plan.

B. Exceptions

The new Nasdaq rule provides exceptions to the shareholder approval requirement for the following types of plans:

- warrants or rights issued generally to all security holders of the company or stock purchase plans available on equal terms to all security holders of the company (such as a dividend reinvestment plan);
- tax qualified employee benefit plans or parallel nonqualified plans, provided that such plans are approved by the company's compensation committee or a majority of the company's independent directors, or plans that merely provide a convenient way to purchase shares on the open market or from the company at fair market value;
- plans or arrangements acquired in the context of an acquisition or merger transaction where outstanding options or other equity compensation awards are converted, replaced or adjusted to reflect the transaction;
- shares available under plans acquired in a merger or acquisition transaction, when used for post-transaction grants;[7] and

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[7] Provided that (1) the number of shares available under the plan is appropriately adjusted to reflect the transaction; (2) the time during which shares are available for grants is not extended beyond the period when they would have been available under the pre-existing plan, absent the transaction; and (3) such options and other awards are not granted to individuals who were employed by the granting company or its subsidiaries at the time the merger or acquisition was consummated.

- inducement grants to a person not previously an employee of the company or following a bona fide period of non-employment, provided such grants are approved by the company's compensation committee comprised of a majority of independent directors or by a majority of the company's independent directors.

With respect to the exemptions for mergers and acquisitions, Nasdaq notes that only plans that exist prior to the transaction (not including any plans or arrangements adopted in contemplation of the transaction) qualify. Furthermore, Nasdaq emphasizes that any additional shares available for issuance under a plan or arrangement acquired in connection with a merger or acquisition will be counted by Nasdaq in determining whether a transaction involves the issuance of 20% or more of the company's outstanding common stock, thereby triggering the shareholder approval requirements under Rule 4350(i)(1)(C).

C. Foreign Issuers

Nasdaq has stated that it intends to continue to exempt foreign private issuers from its corporate governance standards where compliance with such standards would require a company to do anything contrary to the laws, rules, regulations or business practices generally accepted in the company's home country, except to the extent that such an exemption would be contrary to U.S. federal securities laws. It should be noted that under proposed Nasdaq rules, a listed foreign private issuer that obtains exemptions from Nasdaq's corporate governance standards will be required to disclose the exemptions at the time of its IPO or first listing on Nasdaq, as well as in subsequent annual reports filed with the SEC. Such issuers will also be required to disclose any alternative measures taken in lieu of the waived requirements.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning ssues addressed in this memorandum should be directed to any member of the Paul Weiss Securities roup, including:

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