FINAL NYSE AND NASDAQ RULES ON SHAREHOLDER APPROVAL OF EQUITY COMPENSATION PLANS

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I. BACKGROUND.

On June 30, 2003, the Securities and Exchange Commission approved certain proposed rule changes of the New York Stock Exchange (the "NYSE") and the Nasdaq Stock Market, Inc. ("Nasdaq") requiring shareholder approval of equity compensation plans and material revisions to such plans. The new rules are intended to provide shareholders with enhanced protection from the potential dilutive effect of equity compensation plans. The rules are effective June 30, 2003 (the "Effective Date"), subject to transitional relief described below in Part VI. Prior exceptions for "broadly based" plans, plans that deliver only "treasury shares" and plans covering a *de minimis* number of shares have been eliminated, while prior exceptions for inducement grants and plans generally available to all shareholders have been retained. The NYSE and Nasdaq rules are similar in most respects; however, the NYSE rules are significantly more detailed, especially with respect to transition rules for plans in existence prior to the Effective Date and the repricing of stock options.

II. COVERED ARRANGEMENTS.

A. **NYSE Rules**. Under the NYSE rules, shareholders must approve all "equity compensation plans" and any material revisions to the terms of such plans. An "equity compensation plan" means a plan or arrangement (including individual arrangements such as a stand-alone option agreement) that provides for the delivery of equity securities to an employee, director or service-provider as compensation for services rendered. The arrangements described below are not equity compensation plans (even if the company pays for brokerage and other costs of the plan) and are not subject to the compensation committee/board approval and NYSE notice requirements that are applicable to exempt arrangements (as described in subparagraph (viii) of Part III.A).

(i) **Plans Available to All Shareholders**. Arrangements that are available to shareholders generally are not equity compensation plans. A dividend reinvestment plan pursuant to which shareholders may purchase stock directly from the company, i.e., without having to pay brokerage commissions, and direct that dividends paid on such stock be immediately used to purchase additional stock is not an equity compensation plan.

(ii) **Non-Compensatory Plans**. A plan that merely provides a convenient

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mechanism for an employee, director or service-provider to purchase stock at fair market value, i.e., without a discount, from the company or on the open market is not an equity compensation plan. This is the case regardless of whether (1) the shares are delivered immediately or on a deferred basis; or (2) the shares are purchased directly or by giving up compensation that is otherwise due (for example, through payroll deductions). An arrangement that permits an employee to buy shares on the open market or from the issuer at no discount from fair market value with pre-tax contributions funded with payroll deductions is not an equity compensation plan. However, if the employee pays less than fair market value for the shares, the arrangement is considered to be an equity compensation plan.

(iii) **Plans Without Stock Payouts**. Arrangements without stock payouts are not equity compensation plans. A phantom stock award in the form of deferred compensation credits that a company tracks as shares of its common stock (rather than cash) and that is paid out in cash is not an equity compensation plan.

B. **Nasdaq Rules**. Under the new Nasdaq rules, shareholders must approve all stock option or purchase plans and all other equity compensation arrangement pursuant to which options or stock may be acquired by officers, directors, employees or consultants. Shareholders also must approve all material amendments to such plans and arrangements. There is no further explanation regarding the kinds of arrangements that are subject to the shareholder approval requirements; however, certain arrangements are exempt from the shareholder approval requirements, as discussed in Part III.B.

III. EXEMPT ARRANGEMENTS.

A. **NYSE Rules**. An equity compensation plan is nonetheless exempt from the shareholder approval requirements if it falls within one of the exceptions described in subparagraphs (i) through (vii) below, and the conditions described in subparagraph (viii) below are satisfied.

(i) **Employment Inducement Awards**. An award that is a material inducement to an individual's being first hired or rehired after a bona fide interruption of employment is exempt from the shareholder approval requirements. This exception was intended to address the urgency normally associated with promising equity awards to prospective employees and the impracticality of having to obtain shareholder approval of the award. An inducement award includes grants to new employees in connection with a merger or acquisition.

(ii) **Adjustments To Reflect a Corporate Transaction**. The conversion, replacement or adjustment of outstanding options or other equity compensation awards to reflect a merger or acquisition is exempt from the shareholder approval requirements.

(iii) **Post-Transaction Grants to Acquired Company Employees**. Shares that remain available under a plan of a target company acquired in a corporate transaction (such as a merger) may be used for post-transaction awards of equity with respect to the post-transaction, listed entity, either under the target plan or another plan, provided that:

(a) the target plan was not adopted in contemplation of the corporation transaction;

(b) the target plan was approved by the target company's shareholders;

(c) the number of shares available for grant under the target plan is appropriately adjusted to reflect the corporate transaction, i.e., by applying the applicable exchange ratio under the purchase agreement;

(d) the time during which the shares were available under the target plan is not extended; and

(e) the shares are not granted to individuals who were employed immediately prior to the transaction by the listed company or any subsidiary of the listed company.

(iv) **Tax-Qualified Retirement Plans.** Retirement plans that are intended to meet the tax-qualification requirements of section 401(a) of the Internal Revenue Code of 1986, as amended (the "Code") (e.g., employee stock ownership plans and 401(k) plans), are not subject to the shareholder approval requirements. Such plans are regulated by the Code, and U.S. generally accepted accounting principles ("U.S. GAAP") require that shares issued under these plans be treated as a compensation expense on the income statement of the issuing company.

(v) **Section 423 Employee Stock Purchase Plans**. Employee stock purchase plans that are intended to meet the requirements of section 423 of the Code are not subject to the NYSE shareholder approval requirements. The Code requires that these plans receive shareholder approval not later than 12 months after adoption, and the plan, as approved, must specify the aggregate number of shares that may be issued to participants and the employees (or class of employees) eligible to participate in the plan. Also, an employee cannot purchase more than $25,000 worth of stock per year at a discount capped at 15%.

(vi) Retirement Plans and Stock Purchase Plans for Non-U.S. Employees. A plan that provides substantially the same benefits to non-U.S. employees as a retirement or stock purchase plan for U.S. employees described in subparagraph (iv) or (v) above is not subject to the shareholder approval requirements. Features that are included in such a plan to comply with applicable foreign laws (e.g., full vesting requirements) will not result in the failure to provide substantially similar benefits. Note that many companies traditionally maintain retirement and stock purchase plans for non-U.S. employees that do *not* mirror a U.S. retirement or stock purchase plans. Such plans usually are designed according to the laws and customs of the foreign country and may not provide substantially the same benefits as provided under a U.S. plan. Shareholder approval of these plans may have to be obtained.

(vii) Parallel Excess Plans. Parallel excess plans are not subject to the shareholder approval requirements.

(a) Definition of "Parallel Excess Plan." A "parallel excess plan" is a pension plan that operates in parallel with a tax-qualified retirement plan described in subparagraph (iv) above to provide benefits that cannot be provided under the qualified plan because of limits imposed by either section 402(g) (the annual cap on pre-tax employee deferral contributions), section 401(a)(17) (the limit on the maximum amount of compensation that may be taken into account for purposes of benefits) or section 415 (the overall cap on all employee and employer contributions to the qualified plan) of the Code.

(b) Special Requirements for Parallel Excess Plans. A plan is not a parallel excess plan unless:

(1) it covers all or substantially all of an employer's employees who are participants in the related qualified plan and whose annual compensation exceeds the statutory limit under section 401(a)(17) of the Code (for 2003, $200,000);

(2) its terms are substantially the same as the tax-qualified plan that it parallels except for the elimination of the statutory limits imposed by the Code and the limit imposed by subparagraph (3) below; and

(3) no participant receives employer equity contributions under the plan in excess of 25% of the participant's cash compensation. This requirement is intended to address commentators' concern that parallel excess plans are

structured in a way to benefit only highly compensated employees and that participants in such plans could defer up to 100% of their compensation in stock under these plans.

(c) **Effect on Top Hat Plans.** Many common types of parallel excess plans, such as supplemental executive retirement plans ("SERPs"), excess-benefit plans and "benefits restoration" plans, may not cover substantially all employees covered by the qualified plan who earn in excess of $200,000. Such plans, to avoid the funding requirements under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), may only cover a select group of management or highly compensated employees to qualify for the so-called "top hat" exemption under ERISA. Depending on the employer's workforce demographics, it may not be possible for the plan to cover substantially all employees who earn in excess of $200,000 and to still qualify for the ERISA top hat exemption.

(viii) **Conditions To Rely on Exceptions.** In order to rely on one of the exceptions described in subparagraphs (i) through (vii) above, the following requirements must be met:

(a) the plan or arrangement must be approved by the company's independent compensation committee or a majority of the company's independent directors;

(b) the company must provide prior written notice to the NYSE about the specific exemption that is being used (Listed Company Manual § 303A.8); and

(c) in the case of an employment inducement award, the company, promptly following the grant, must disclose in a press release the material terms of the award, including the identity of the grantee and number of shares.

Note that any shares reserved for listing in connection with a merger or acquisition pursuant to either of the exemptions described in subparagraph (ii) or (iii) above must be counted in determining whether the transaction involves the issuance of 20% or more of the company's outstanding common stock and thus requires shareholder approval under the NYSE listed company manual § 312.03(c).

B. **Nasdaq Rules**.

(i) **Exempt Arrangements.** The following arrangements are exempt from the Nasdaq shareholder approval requirements:

(a) a warrant or right issued generally to all shareholders;

(b) an arrangement described in subparagraph (i), (ii) or (iii) of Part II.A above;

(c) an arrangement described in subparagraph (i), (iv), (v) or (vii) of Part III.A above if it is approved by either the company's compensation committee comprised of a majority of independent directors or a majority of the company's independent directors; and

(d) an arrangement or transaction described in subparagraph (ii) or (iii) of Part III.A above, without any committee or board approval.

(ii) Transactions Involving 20% or More of Company's Stock. Any additional shares available for issuance under the plan or arrangement acquired in a connection with a merger or acquisition must be counted in determining whether the transaction involves the issuance of 20% or more of the company's outstanding common stock, thus triggering the shareholder approval requirements under Nasdaq Rule 4350(i)(1)(C).

(iii) Nasdaq Notification/Press-Release Requirements. The Nasdaq rules now require that a company notify Nasdaq on an appropriate form no later than 15 calendar days prior to establishing or materially amending a stock option plan, purchase plan or other stock arrangement pursuant to which stock may be acquired by officers, directors, employees or consultants unless shareholder approval has been obtained. Previously, the requirement only applied if the arrangement was made available to officers or directors, i.e., notice was not required if the arrangement was broadly-based and did not cover officers or directors. The availability of the exemptions described above, however, does not appear to be contingent upon satisfying the notice requirement. Nasdaq is considering such a requirement. In addition, the Nasdaq rules currently do not require the issuance of a press release in connection with the grant of an employment inducement award.

IV. MATERIAL REVISIONS REQUIRING SHAREHOLDER APPROVAL.

A. NYSE Rules. The NYSE rules require shareholder approval of any "material revision" to an equity compensation plan. An amendment is not considered a "material revision" if it curtails rather than expands the scope of the plan. The following is a non-exhaustive list of material revisions that require shareholder approval under the NYSE rules:

(i) **Material Increase in Shares**. A material increase in the number of shares available under the plan (other than an increase solely to reflect a reorganization, stock split, merger, spin-off or other similar transaction) requires shareholder approval.

(a) **Special Rule for "Formula Plans."** A special rule applies to "formula plans." A formula plan is a plan that, by operation of its terms, provides for either (1) automatic increases in the plan's share reserve (i.e., under an "evergreen formula"); or (2) automatic grants to individuals (such as non-employee directors). Each automatic increase or grant under a formula plan is considered to be a material revision requiring shareholder approval unless the plan contains a term of 10 years or less. If a plan does not have a term of 10 years or less, the company can amend the plan to include such a term.

(1) **Example.** A company's omnibus, shareholder-approved equity incentive plan includes an evergreen formula, which provides that as of January 1 of each year, commencing with the year 2004, the aggregate number of grants that may be awarded under the plan shall automatically increase by a number equal to the lower of (a) 3% of the total number of shares of common stock then outstanding; or (b) 100,000 shares of common stock. Each annual increase in the number of shares is a material revision that requires shareholder approval unless the plan's term is not more than 10 years.

(2) **Example.** A company's omnibus equity incentive plan provides that upon the conclusion of each regular annual meeting of the company's shareholders held in the year 2004 or thereafter, each outside director who will continue serving as a member of the board of directors shall receive a non-statutory stock option covering 5,000 shares of common stock. Each automatic director grant is a material revision that requires shareholder approval unless the plan's term is not more than 10 years.

(b) **Special Rule for "Discretionary Plans."** A special rule applies to "discretionary plans." A "discretionary plan" is a plan that does not contain a cap on the number of shares available for issuance and that does not satisfy the definition of a "formula plan" under Part IV.A(i)(a). Each grant under a discretionary plan requires shareholder approval regardless of whether the plan's term is limited to 10 years. The traditional treasury stock exception is no longer available. A plan that exclusively uses treasury shares or company repurchased shares for grants is not, in itself, considered to have a limit or pre-established formula so as to avoid treatment as a discretionary plan.

(ii) **Expansion of Type of Awards.** An expansion of the types of awards under the plan (e.g., amending a stock option plan to provide for the grant of restricted stock) is a material revision requiring shareholder approval.

(iii) **Material Expansion of Covered Individuals**. A material expansion of the class of employees, directors or other service-providers eligible to participate in the plan (e.g., amending a non-employee director plan to provide grants to employees) is a material revision requiring shareholder approval.

(iv) **Material Extension of Plan's Term**. A material extension of the term of the plan is a material revision requiring shareholder approval.

(v) **Material Change To Determine Fair Market Value**. A material change to the method of determining the strike price of the options is a material revision requiring shareholder approval. An example of a change that is not viewed as material includes 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.

(vi) **Deletion or Limitation of Repricing Prohibition.** The deletion or limitation of any provision that prohibits the repricing of stock options is a material revision requiring shareholder approval.

(vii) **Repricing of Stock Options.** The repricing of stock options in the absence of an express provision in the plan document that authorizes such repricing is considered to be a material revision that requires shareholder approval. A plan that does not specifically permit repricing is considered to prohibit repricing. Any action to reprice a stock option is considered to be a material revision even if the plan document itself is not revised.

(a) **Definition of Repricing**. For purposes of the NYSE Rules, the term "repricing" means any of the following or any other action that has the same effect:

(1) lowering the strike price of an option after it is granted;

(2) any other action that is treated as a repricing under U.S. GAAP (see subparagraph (b) below); and

(3) canceling an option at any 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 other similar corporate transaction.

A cancellation and exchange described in subparagraph (3) above is treated as a repricing regardless of whether the option, restricted stock or other equity is delivered simultaneously with the cancellation, regardless of whether it is treated as a repricing under U.S. GAAP and regardless of whether it is voluntary on the part of the option holder. Note that six-months-and-one-day exchange offers and other kinds of repricings that do not trigger variable accounting treatment under U.S. GAAP are treated as repricings under the NYSE rules and require shareholder approval. The NYSE rules only exempt repricings through exchange offers that started prior to the June 30, 2003, the effective date of the new rules.

(b) **Actions Treated as a Repricing Under U.S. GAAP**. Under U.S. GAAP, any direct or indirect reduction in the exercise price of a fixed stock award is considered a repricing, including:

(1) the grant of a cash bonus that is paid only if the option is exercised;

(2) an option that allows the grantee to exercise with a full-recourse note that does not bear a market interest rate;

(3) a reduction in the exercise price contingent upon the occurrence of a certain event, e.g., the attainment of an earnings target or stock price;

(4) any cancellation of an option with a promise to grant a new option in the future and to protect the optionee from price increases;

(5) the grant of an option with a promise to cancel other higher priced options in the future; and

(6) any cancellation and grant of an option within six months of each other.

B. **Nasdaq Rules**. The Nasdaq rules require shareholder approval of any “material amendment” to a plan or other equity compensation arrangement, regardless of whether the board of directors, an officer or any other person retains *general* authority under the terms of the plan to amend the plan. However, if the board of directors, an officer or any other person has *specific* authority under the plan document to take an action that would be a material amendment, then shareholder approval of the amendment generally would not be required.

(i) Non-Exhaustive List of Material Revisions. The Nasdaq rules provide the following non-exhaustive list of material amendments that require shareholder approval, which are similar and, in some cases, identical to "material revisions" under the NYSE rules:

(a) any material increase in the number of shares to be issued under the plan (other than to reflect a reorganization, stock split, merger, spin-off or similar transaction);

(b) any material increase in benefits to participants, including any material change to: (1) permit a repricing (or decrease in exercise price) of outstanding options; (2) reduce the price at which shares or options to purchase shares may be offered; or (3) extend the duration of a plan;

(c) any material expansion of the class of participants eligible to participate in the plan; and

(d) any expansion in the types of options or awards provided under the plan.

Note that a "material increase in benefits" does not appear in the list of "material revisions" under the NYSE rules and may cover a broad range of transactions, e.g., amending the stock options of a certain group of employees to provide for full vesting on a change in control. Obtaining oral or written guidance from the Nasdaq prior to materially increasing benefits for participants is advisable.

(ii) Special Rule for "Formula Plans." A formula plan (as defined Part IV.A(i)(a)) cannot have a term in excess of 10 years unless shareholders approve the plan every 10 years.

(iii) Special Rule for "Discretionary Plans." Each grant under a discretionary plan (as defined in Part IV.A(i)(b)) must be approved by shareholders. A requirement that grants be made out of treasury shares or repurchased shares does not avoid the application of this special rule.

(iv) Repricing of Stock Options.. The Nasdaq rules do not mirror the NYSE rules regarding the repricing of stock options. Under the above list a material amendment clearly includes any amendment to a plan to permit the repricing or the reduction in exercise price of outstanding options. However, it is unclear whether an indirect repricing or any action that does not directly reduce the exercise price but constitutes a repricing under U.S. GAAP (see Part IV.A(vii)(b)) is a material amendment, even if the plan document is not revised or is silent on repricing. The absence of transitional relief for exchange offers under the Nasdaq that started prior to the effective date of the rules may be an indication that such a repricing is not considered a material amendment; however, it may be advisable to obtain either oral or written guidance from Nasdaq before undertaking any direct or indirect repricing of stock options.

V. BROKER VOTING

A. **NYSE Rules.** Member organizations (i.e., brokers who are members of the NYSE) are prohibited from giving a proxy to vote on equity-compensation plans unless the beneficial owner of the shares has given voting instructions. The rule is effective for any meeting of shareholders that occurs on or after September 28, 2003. Generally under NYSE rules, only matters that are considered routine are allowed to be voted on by a broker on behalf of a beneficial owner. This change may make it more difficult to obtain shareholder approval of equity compensation plans. Previously, brokers were permitted to give proxies to the management of the companies for standard proposals when the beneficial owners had not given them voting instructions.

B. **Nasdaq Rules.** The new Nasdaq rules do not address broker-dealer discretionary voting because existing Nasdaq rules already prohibit discretionary voting by broker-dealers without explicit instructions from the beneficial owner.

VI. TRANSITION AND GRANDFATHERING RELIEF FOR PRE-EFFECTIVE DATE PLANS

A. **NYSE Rules**. A plan adopted prior to June 30, 2003 is exempt from the shareholder approval requirements until it is "materially revised" (see Part IV.A for definition). The NYSE rules provide special transition relief for material revisions to pre-effective date discretionary and formula plans (as defined in Parti IV.A(i)).

(i) **Transition Rule for "Discretionary Plans."** Additional grants under a discretionary plan, regardless of whether the plan has been approved by shareholders, can continue to be made during the transition period only (as defined in Part VI.A(iii) below) in a manner consistent with past practice. After the transition period is over, additional grants can only be if shareholder approval is obtained for each grant. If a plan can be separated into a discretionary plan portion and a portion that is not discretionary, the non-discretionary portion of the plan can continue to be used separately under the appropriate transition rule. For example, if a shareholder-approved plan permits both grants pursuant to a provision that makes available a specific number of shares, and grants pursuant to a provision authorizing the use of treasury shares without regard to the specific share limit, the former provision (but not the latter) may continue to be used after the transition period, under the general rule above.

(ii) **Transition Rule for "Formula Plans."** Awards under automatic share-increase or grant provisions of a formula plan without a 10-year term, regardless of whether it is shareholder-approved, may continue to be made *during the transition period only*. Note that this has no relation to shares that were already available under the plan as of June 30, 2003 (including shares pursuant to formulaic increases prior to June 30, 2003), as awards may be made with respect to such shares under the general grandfathering relief that is provided. In the case of a shareholder-approved plan, awards under automatic increase or grant provisions may be made *after the transition period is over* only if the plan has been amended to include a 10-year term. In the case of a non-shareholder-approved plan *or* a shareholder-approved plan that has not been amended to include a term of 10 years or less, awards under automatic increase or grant provisions cannot be made after the transition period unless (a) in the case of a non-shareholder-approved plan, shareholder approval is obtained; or (b) in the case of a shareholder-approved plan, the plan is amended to include a term of 10 years or less.

(iii) **The Transition Period**. The transition period under the NYSE rules ends on the earliest of (i) the next annual meeting at which directors are elected that occurs on or after December 28, 2003, (ii) June 30, 2004, or (iii) the date the plan expires.

B. **Nasdaq Rules**. Generally, a plan, including a formula or discretionary plan, adopted prior June 30, 2003 is exempt from the shareholder approval requirements until it is "materially amended" (see Part IV.A for definition).

VII. CONCLUSION.

Listed companies may wish to identify all of their equity compensation arrangements that could potentially be subject to the new NYSE and Nasdaq rules. These can include arrangements not typically considered "plans," such as discretionary grants of options or other equity securities to a service-provider granted outside of a shareholder-approved plan.

Listed companies may wish to focus in particular on whether they have any "formula" or "discretionary" plans, as these plans may be available in their current form only for the limited transition period without requiring shareholder approval and amendments to limit their terms to 10 years or less. Formula plans may include not only plans with evergreen formulas and automatic director grant provisions but also plans such as nonqualified deferred compensation plans that provide for company "matching" contributions in the form of company stock.

If a listed company provides a nonqualified excess benefits plan that includes participant-directed investments in company stock, the company should consider plan amendments that may qualify the plan as a "parallel excess plan" exempt from the shareholder approval rules. In this regard, note that many of those plans also intend to qualify as "top hat" plans exempt from many of the requirements of ERISA, as discussed above. The company may wish to consider the impact of any plan amendments expanding the class of individuals eligible to participate on the availability of the "top hat" exemption under ERISA.

Any NYSE or Nasdaq company considering an amendment to an equity compensation plan, including individual stock option agreements granted outside of a plan, needs to consider whether the amendment would be a "material revision/amendment" requiring shareholder approval. A material increase in benefits to participants may result in a "material amendment" under the Nasdaq rules. When relying on an exemption from shareholder approval for the adoption or amendment of an equity compensation plan or award, the company must determine whether it is necessary to obtain approval of the company's independent compensation committee (or a majority of the independent directors), and what notice and disclosure requirements apply.