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Advisory

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SECURITIES LAW

NYSE and Nasdaq Rules Requiring Shareholder Approval of Equity Compensation Plans

Effective June 30, 2003, the Securities and Exchange Commission (SEC) approved rule changes initially proposed in the fall of 2002 by the New York Stock Exchange (NYSE) and the National Association of Securities Dealers, through its subsidiary, The Nasdaq Stock Market (Nasdaq), relating to shareholder approval of equity compensation plans.¹

Commencing June 30, 2003, companies listed on Nasdaq or the NYSE are required to obtain shareholder approval in order to adopt new equity compensation plans or make material amendments to existing equity compensation plans, subject to certain limited exceptions discussed in this Advisory. Existing equity compensation plans adopted prior to June 30, 2003, will not require shareholder approval unless and until they are materially amended.

In addition, the SEC approved a companion rule that will prohibit brokers from voting on the approval of an equity compensation plan unless the broker has received specific voting instructions from the beneficial owner of the shares. Prior to the new rule's adoption, brokers who did not receive specific voting instructions from share owners could nonetheless vote to approve equity compensation plans or amendments to plans that involved less than 5% of a company's outstanding shares. This rule became effective for shareholder meetings taking place on or after September 28, 2003.

The newly approved rules under Section 303A(8) of the NYSE's Listed Company Manual and NASD Rule 4350(i) are similar, but not identical. This Advisory discusses the rules and highlights the similarities and differences between the NYSE and Nasdaq rules.²

What is an Equity Compensation Plan?

An equity compensation plan is a plan or arrangement pursuant to which equity compensation may be acquired by officers, directors, employees or consultants (the NYSE rule broadens the definition to include grants to

¹ SEC Release No. 34-48108 (June 30, 2003).

² The SEC has approved a similar rule that amends Section 711 of the Amex Company Guide. In addition, the regional stock exchanges, such as the Boston Stock Exchange and the Philadelphia Stock Exchange have approved rules substantially similar to Nasdaq's revised rule.

other service providers as well). This includes the grant of options or other equity securities that are not made under a plan and covers issuances of both newly-issued shares and treasury shares.³

The following are excluded from the definition of an equity compensation plan requiring shareholder approval:

- plans that do not provide for the delivery of equity securities of the issuer, such as phantom stock awards settled only in cash;
- plans that are made available to shareholders generally, such as dividend reinvestment plans (these plans are excluded from the definition of an equity compensation plan by the NYSE rule and exempted from the shareholder approval requirements under the Nasdaq rule); and
- plans that merely allow for the election to buy shares on the open market or from the company at current fair market value.

What Constitutes a Material Revision/Amendment to an Equity Compensation Plan?

The new rules require shareholder approval whenever a new equity compensation plan is adopted. In addition, material amendments to equity compensation plans will require shareholder approval. Nasdaq and the NYSE have similar definitions as to what constitutes a material amendment to a plan. Each provides a non-exhaustive list of material revisions and both provide additional information with respect to analyzing whether

other changes would be deemed to be material.

NYSE: Under the NYSE rule, a material revision includes, but is not limited to, the following:

- 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 similar transaction);
- 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; and
- the deletion or limitation of any provision prohibiting repricing of options.

The NYSE rule clarifies that any amendment which curtails rather than expands the scope of an equity compensation plan is not considered to be a “material revision” which would require shareholder approval for NYSE listed companies.

In addition, the FAQs clarify that a material revision is anything that has the effect of materially increasing the potential dilution to shareholders over the lifetime of the plan. The FAQs give further specific examples of material and non-material amendments to a plan.

Nasdaq: Under the Nasdaq rule, a material amendment includes, but is not limited to, the following:

- 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);
- any material increase in benefits to participants, including any material change to: (i) permit a repricing 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.

The Nasdaq rule states that a shareholder-approved plan may explicitly permit a specific action to be taken under the plan without further shareholder approval. However, the SEC noted in its adopting release that in order to take advantage of this ability, the plan language must be clear and specific enough to have provided meaningful shareholder approval of those provisions. In addition, plans containing “evergreen” provisions for automatic annual share increases or provisions for automatic grants may not have a term in excess of ten years unless shareholder approval is obtained every ten years. Further, a requirement that grants be made only out of treasury shares or repurchased shares will not alleviate the additional shareholder approval requirement.

³ On December 16, 2003, the NYSE released guidance on its rule in the form of frequently asked questions (FAQs). The guidance includes descriptions of certain equity arrangements NYSE deems equity compensation plans covered by this rule.

What Grants of Equity Compensation are Exempt From the New Shareholder Approval Requirements?

Both the NYSE and Nasdaq provide that shareholder approval will not be required for (i) employment inducement awards, (ii) certain grants, plans and amendments in the context of mergers and acquisitions, and (iii) certain specific types of plans. As with other aspects of the new rule, there are minor differences between the NYSE and Nasdaq versions.

NYSE: If grants are made under any of the following exemptions, they must be made only with the approval of the company's independent⁴ compensation committee or the approval of a majority of the company's independent directors.

Employment Inducement Awards –

A grant of an option or other equity-based compensation as a material inducement to a person being hired by a company or any of its subsidiaries, or being rehired following a *bona fide* period of interruption of employment. Inducement awards include grants to new employees in connection with a merger or acquisition.

Mergers and Acquisitions – The conversion, replacement or adjustment of outstanding options or other equity-compensation awards to reflect a merger or acquisition will not require shareholder approval under the new NYSE rule. Furthermore, shares available under pre-existing shareholder-approved plans of a company that will not be a listed company following the transaction may be used for certain post-transaction grants without further shareholder approval, as discussed below. A plan adopted in contemplation of a merger or acquisition transaction would not be considered “pre-existing” for purposes of this exemption.

The company which becomes or remains listed after the transaction may use the shares available under an acquired company's pre-existing plan for post-transaction grants of options and other awards either under the pre-existing plan or another plan, without further shareholder approval, so long as:

- the number of shares available for grants is appropriately adjusted to reflect the transaction;
- the time during which those shares are available for grant is not

extended beyond the period when they would have been available under the pre-existing plan, absent the transaction; and

- 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.⁵

Tax Qualified Plans, Section 423 Plans and Parallel Excess Plans. –

Plans intended to meet the requirements of Section 401(a) of the Internal Revenue Code (IRC), such as profit sharing plans, 401(k) plans and ESOPs, and plans intended to meet the requirements of Section 423 of the IRC are exempt from the shareholder approval requirement. Section 423 plans are stock purchase plans under which an employee can purchase company stock at a plan-specified discount capped at 15%. These 423 Plans are required by the IRC to receive shareholder approval in any event.

Parallel excess plans⁶ are also exempt from the shareholder approval requirement.⁷

⁴ See Section 303A of the NYSE Listed Company Manual for the definition of independence.

⁵ Any shares reserved for listing in connection with a transaction pursuant to the “mergers and acquisitions” exemption would be counted by the NYSE in determining whether the transaction involved the issuance of 20% or more of the company's outstanding common stock and thus required shareholder approval under Listed Company Manual Section 312.03(c).

⁶ The NYSE defines a parallel excess plan and Nasdaq defines a parallel nonqualified plan as a plan that is a “pension plan” within the meaning of the Employee Retirement Income Security Act (ERISA) that is designed to work in parallel with a plan intended to be qualified under IRC Section 401(a) to provide benefits that exceed the limits set forth in IRC Section 402(g) (the section that limits an employee's annual pre-tax contributions to a 401(k) plan), IRC Section 401(a)(17) (the section that limits the amount of an employee's compensation that can be taken into account for plan purposes) and/or IRC Section 415 (the section that limits the contributions and benefits under qualified plans). The rule also requires any parallel excess or parallel nonqualified plan to (i) cover all or substantially all employees of an employer who are participants in the related qualified plan whose annual compensation is in excess of the limit of IRC Section 401(a)(17); (ii) have substantially the same terms as the qualified plan that it parallels except for the elimination of the limits described in the preceding sentence and the variation allowed by the following clause (iii); and (iii) prohibit any participant from receiving employer equity contributions under the plan in excess of 25% of the participant's cash compensation.

⁷ An equity compensation plan that provides non-U.S. employees with substantially the same benefits as a comparable IRC Section 401(a) plan, IRC Section 423 plan or parallel excess or nonqualified plan that a listed company provides to its U.S. employees, but for features necessary to comply with applicable foreign tax law, is also exempt from shareholder approval.

Nasdaq: The following grants of equity compensation are exempt from the shareholder approval requirements of the new Nasdaq rule.

Employment Inducement Awards – Grants to new employees of the company or to former employees following a *bona fide* period of non-employment, as an inducement material to the individual's entering into employment with the company are exempt from the shareholder approval requirements, provided those issuances are approved by either the issuer's independent⁸ compensation committee or a majority of the issuer's independent directors.⁹

Mergers and Acquisitions – With regard to plans or arrangements involving a merger or acquisition, shareholder approval will not be required to convert, replace or adjust outstanding options or other equity compensation awards to reflect the transaction. Further, shares available for grant under pre-existing shareholder-approved plans may be used for certain post-transaction grants without further shareholder approval, as discussed below. Plans and arrangements adopted in contemplation of the merger or acquisition are not considered to be "pre-existing" by Nasdaq for purposes of this exception.¹⁰

Shares available under a plan of a company that will not be a listed company after the merger or acquisition may be used for grants of options and other equity awards by the listed

company, either under the pre-existing plan or arrangement or another plan or arrangement, without further shareholder approval, as long as:

- the number of shares available for grants is appropriately adjusted to reflect the transaction;
- the time during which those 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
- the options and other awards are not granted to individuals who were employed by the acquiring company or its subsidiaries at the time the merger or acquisition was consummated.

Tax Qualified Plans, Parallel Non-Qualified Plans and Plans Available to Shareholders Generally – Shareholder approval will not be required for tax qualified, non-discriminatory employee benefit plans (*e.g.*, profit sharing plans, 401(k) plans, ESOPs, and plans intended to meet the requirements of Section 423 of the IRC) or parallel nonqualified plans (see footnotes 5 and 6), provided such plans are approved by the issuer's independent compensation committee or a majority of the issuer's independent directors. Plans that merely provide a convenient way to purchase shares on the open market or from the issuer at fair market value also will not require shareholder approval.

Do I Need to Issue a Press Release or Notify the NYSE or Nasdaq If I Grant Equity Compensation Without Shareholder Approval?

NYSE: Yes. Listed companies must notify their listing representative at the NYSE in writing or electronically when they use one of the exemptions described above. Moreover, promptly following a grant of any inducement award in reliance on that exemption, a listed company must disclose in a press release the material terms of the award, including the recipient of the award and the number of shares involved. The FAQs clarify the timing of and information required in the press release.

Nasdaq: Yes. Listed companies must notify Nasdaq by filing the appropriate form no later than 15 calendar days prior to establishing or materially amending a plan without shareholder approval. In addition, Nasdaq revised its rule on October 14, 2003, and now requires the same public disclosure by way of press release as the NYSE in connection with grants of inducement awards.

What Prior Exemptions From Shareholder Approval Do the New NYSE and Nasdaq Rules Eliminate?

Both the new NYSE rule and the new Nasdaq rule eliminate the exemption from the shareholder approval

⁸ See Rule 4200(a) of the NASD Manual for the definition of independence.

⁹ Inducement awards may include grants to new employees in connection with a merger or acquisition.

¹⁰ Any additional shares available for issuance under a plan or arrangement acquired in connection with a merger or acquisition would be counted by Nasdaq in determining whether the transaction involved the issuance of 20% or more of the company's outstanding common stock, thus triggering the shareholder approval requirements under Rule 4350(i)(1)(C).

requirements that previously existed for “broadly based” equity compensation plans. The prior exemption under the NYSE rule for grants of treasury shares under equity compensation plans or other arrangements has also been eliminated, as well as the Nasdaq exemption for plans issuing *de minimis* share amounts.

What If I Have an Evergreen Provision in My Stock Plan or If My Stock Plan Contains No Limit on the Number of Shares Available for Grant?

NYSE: Plans containing an evergreen provision providing a formula for automatic increases in the shares available, or plans containing automatic grants pursuant to a formula, are referred to as “formula plans” under the new NYSE rule.¹¹ If a shareholder-approved formula plan has a term of not more than ten years, shareholder approval is not required for each increase or grant under the plan.

The NYSE rule refers to a plan containing no limit on the number of shares available for issuance and which is not a formula plan as a “discretionary plan.” Each grant under a discretionary plan will now require separate shareholder approval regardless of whether or not the plan was previously approved by shareholders.

Transition rules: The NYSE rule provides for a transition period during which certain increases and grants under formula plans and discretionary

plans may continue to be made without shareholder approval. In the case of a formula plan that either has not previously been approved by shareholders or does not have a term of ten years or less, additional grants may be made after June 30, 2003, without further shareholder approval for the limited transition period defined below. A shareholder-approved formula plan that does not have a ten-year term may continue to be used (and new shares may continue to be added to the plan each year) after the end of the transition period if it is amended to provide for a term of ten years from the date of its original adoption or, if later, the date of its most recent shareholder approval. A formula plan that was not approved by shareholders may continue to be used after the end of the transition period, without shareholder approval, if the grants after June 30, 2003 are made only from the shares available immediately before June 30, 2003 (based on formulaic increases that occurred prior to June 30, 2003).

The limited transition period referenced above will end upon the first to occur of:

- the listed company’s next annual meeting at which directors are elected that occurs after December 27, 2003;
- June 30, 2004; and
- the expiration of the plan.

In the case of a discretionary plan, additional grants may be made after

June 30, 2003, without further shareholder approval only for the limited transition period defined below, and then only in a manner consistent with past practice.¹²

Nasdaq: A plan containing an evergreen formula for automatic increases in the shares available under the plan or containing automatic grants pursuant to a dollar-based formula (such as annual grants based on a certain dollar value, or matching contributions based upon the amount of compensation the participant elects to defer) may not have a term longer than ten years. A plan imposing no limit on the number of shares available for grant requires shareholder approval of each grant under the plan.

The Nasdaq rule does not include any transition provision for plans containing an evergreen provision with a term longer than ten years or for plans imposing no limit on the number of shares available for grant. For plans containing an evergreen provision, Nasdaq has stated orally that these plans can continue in effect beyond June 30, 2003, until ten years from their initial adoption or the date of the most recent shareholder approval, and that formulaic increases can continue to be made during such time. For plans that impose no limit on the number of shares available for grant, shareholder approval will be required after June 30, 2003, for each new grant under the plan.

¹¹ The FAQs clarify that plans that have a fixed number of shares are neither “formula plans” nor “discretionary plans” simply because they contain a formula for the granting of shares if the shares granted under the formula count against the maximum reserve.

¹² In applying this rule, 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 (unless and until it is materially amended).

May I Continue to Reprice Options Without Shareholder Approval?

NYSE: Under the new NYSE rule, a plan that does not contain a provision that specifically permits repricing of options is viewed as prohibiting repricing. Accordingly, any actual repricing of options under a plan which does not specifically permit repricing will be considered a material revision of the plan, requiring shareholder approval, even if the plan itself is not revised.

“Repricing” means any of the following 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 similar corporate transaction.

Nasdaq: Nasdaq and the SEC recommend that plans meant to permit repricing use explicit terminology to make this clear. If a company is considering repricing or implementing

a six-month and one-day exchange offer and does not have specific language allowing for these transactions in its plan, Nasdaq has indicated that the company should consult with its listing representative to determine, based on the facts and circumstances, whether such a transaction would be deemed to be material and require shareholder approval before its implementation. We understand that Nasdaq may provide further written guidance in this area.

Elimination of Brokers' Discretionary Voting Authority

Under the former version of NYSE Rule 452, a NYSE member broker could use its discretionary authority to vote on equity compensation plan proposals that involved less than 5% of the outstanding shares of a listed company.¹³ Amended Rule 452 prohibits brokers from voting on any equity compensation plan unless they receive specific voting instructions from the beneficial owner of the shares.

When a nominee (usually a broker) holding shares for a beneficial owner does not vote on a particular proposal because the nominee does not have discretionary voting power with respect to that proposal and has not received voting instructions from the beneficial owner, the result is referred

to as a “broker non-vote.” For purposes of tabulating the vote on any particular proposal, state law and a company’s by-laws will dictate whether these broker non-votes either count as votes against a proposal or have no impact on the voting. In either case, under this new rule, only shareholders who either vote in person or provide their nominee with specific instructions may vote on equity compensation plan proposals. The new rule may make it more difficult to obtain the requisite affirmative vote since most beneficial owners, other than employees and management, who typically vote on equity compensation plans are institutional shareholders, and these institutional investors do not necessarily always vote in favor of equity compensation plan proposals. Companies that have not used proxy solicitors in the past should consider retaining their services in order to increase the likelihood of approval of equity compensation plan proposals.

Amended Rule 452 became effective for shareholder meetings taking place on or after September 28, 2003.

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Please contact the Mintz Levin attorney who handles your corporate and securities law matters if you have any questions or concerns regarding this information.

¹³ This rule extends beyond NYSE issuers to shares of Nasdaq and Amex issuers because the rule applies to NYSE “member organizations” which are all NYSE regulated broker-dealers.