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## Stockholder Approval Required for Equity Compensation Plans

The New York Stock Exchange (NYSE) and the NASDAQ Stock Market (NASDAQ) have adopted changes to their rules governing stockholder approval of equity compensation plans. Under revised NYSE and NASDAQ rules effective June 30, 2003, a listed company's stockholders must approve most new equity compensation plans to be adopted by a listed company. Any "material revision" to existing plans also now requires stockholder approval.

### *What constitutes an equity compensation plan?*

Under NYSE rules, an "equity compensation plan" is a plan or other arrangement that provides for the delivery of equity securities (either newly issued or treasury shares) to any employee, director or other service provider as compensation for services. The NASDAQ rules cover all stock option or purchase plans as well as any other equity compensation arrangement where employees, officers, directors or other consultants of the company may acquire options or stock. The compensatory grant of securities need not be under a plan to be considered an "equity compensation plan."

### *What do NYSE and NASDAQ consider "material revisions" requiring stockholder approval?*

First, NYSE and NASDAQ define as material any increase in the number of securities available for grant under an equity compensation plan.<sup>1</sup> Plans with evergreen formulas and discretionary plans are deemed materially amended each time grants are made thereunder. "Evergreen formulas" provide for built-in, automatic increases in the number of shares available or automatic grants pursuant to a formula. However, evergreen formula plans with terms of no more than ten years will *not* require separate stockholder approval for each automatic increase or grant. "Discretionary plans" are plans with no limitations on the number of shares that may be issued. Each grant of securities under this type of plan requires stockholder approval, regardless of the term of the plan.

Second, NYSE and NASDAQ deem material any material expansion to a plan.<sup>2</sup> Material expansion includes:<sup>3</sup>

- expanding the types of awards available under a plan,
- materially expanding the class of employees, directors, or other service providers capable of participating in a plan,
- materially extending the term of a plan,
- materially changing the method of determining the strike price of options under a plan, or
- deleting or limiting any provision prohibiting repricing of options (NYSE) or permitting a repricing (NASDAQ).

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<sup>1</sup> Material changes are not limited only to those summarized in this advisory. NYSE and NASDAQ may deem other changes to be material.

<sup>2</sup> If an amendment limits a plan rather than expands a plan, the limiting amendment is not considered material.

<sup>3</sup> The NYSE and NASDAQ lists of examples of material revisions differ in wording. This list is meant only as a summary.

### ***What is repricing?***

NYSE defines repricing as lowering the strike price of an option after it has been granted, canceling an option when its strike price exceeds the fair market value of the underlying stock in exchange for another option or any other action treated as a repricing under GAAP. Companies consider repricing options when a company's stock price does not increase in value above the strike price of the options. Because options are intended to encourage employees, when the strike price set at the time of grant is lower than the subsequent stock price, the incentive normally provided by the options will diminish or no longer exist.

NYSE prohibits repricing without stockholder approval unless expressly permitted by the plan. Any plan that does not specifically provide for repricing will be considered to prohibit repricing. NASDAQ rules leave up to the company decisions on inclusion of repricing clauses. It does not offer any other guidelines other than that a material change to a plan to permit repricing requires stockholder approval.

### ***When may companies not seek stockholder approval for equity compensation plans?***

The following are specifically exempt from the requirement for stockholder approval:<sup>4</sup>

- Warrants or rights offered to all stockholders or plans generally available to all stockholders (e.g., dividend reinvestment plans).
- Plans merely allowing employees, directors, or other service providers to purchase securities on the open market or from the listed company at their current fair market value.
- Employment inducement awards when the company grants securities to new hires as an incentive to work for the company. This includes giving securities to former employees who have spent a "bona fide" time away from the company. When relying on this exemption, NYSE companies must issue a press release, which includes the name of the recipient, the number of shares granted and any other material terms.
- Plans related to mergers and acquisitions in two specific situations: (1) if equity is used to convert, replace or adjust outstanding options or other equity compensation plans to reflect the transaction, stockholder approval is not required; and (2) if the party which is not a listed company following the transaction has available securities for grant under plans that were pre-approved by the acquired company's stockholders prior to the transaction, as long as there are no material revisions to the original plan in connection with the transaction, stockholder approval is not required.<sup>5</sup>
- Qualified or parallel excess plans. Tax qualified, non-discriminatory employee benefit plans do not need stockholder approval because the Internal Revenue Code (IRC) already regulates them under Sections 401(a) and 423. These plans include many 401(k), employee stock ownership and employee stock purchase plans. A "parallel excess plan" is a pension plan as defined by the Employee Retirement Income Security Act (ERISA) that is designed to work in parallel with an IRC 401(a) plan to provide certain excess benefits. Parallel excess plans do not require stockholder approval if they meet certain requirements.

For NYSE companies, these exempt grants, plans and amendments require the approval of a company's independent compensation committee or a majority of a company's independent directors. For NASDAQ companies, exempt grants that are

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<sup>4</sup> NYSE rules require that the issuer notify NYSE in writing before relying on any of the following exemptions.

<sup>5</sup> None of the securities under such a plan may be granted to employees working for the acquiring company who were not employees of the acquired company before the transaction. In addition, no time frames may be extended beyond what was available in the pre-existing plan.

employment inducements or qualified plans or parallel nonqualified plans require approval of the company's compensation committee or a majority of the company's independent directors.

***May brokers vote on plans submitted for stockholder approval?***

Under the new NYSE rules, brokers cannot vote on equity compensation plans unless the beneficial owner of the shares has given specific voting instructions. In the past, when companies called for a stockholder vote, many stockholders would fail to respond to the request for instructions as to how to vote. In that event, a member organization holding those shares had been allowed to vote the shares at its own discretion. Effective September 28, 2003, the NYSE rules will forbid member organizations from doing this. Absent beneficial stockholders explicitly instructing the organization how to vote on a plan, brokers may not exercise discretion. The NASD already prohibited member organizations from voting shares as to which they do not have explicit instructions.

***Do existing plans need stockholder approval?***

Under NYSE rules, plans adopted prior to June 30, 2003 do not require stockholder approval until they are materially revised. Evergreen formula plans with terms longer than ten years and discretionary plans existing prior to June 30, 2003 can be used until the earliest of the following occurs: 1) the company's next annual meeting occurring after December 27, 2003; 2) June 30, 2004; or 3) expiration of the plan. After that time, such plans may not be used if stockholders have not approved them. NASDAQ did not specify any transition guidelines. Plans existing prior to June 30, 2003 are therefore grandfathered until a material revision is required to be approved by stockholders, but with no transition period for evergreen formula plans or discretionary plans.

***How do the new and old rules differ?***

The rule changes redefined which plans require stockholder approval. The new NYSE and NASDAQ rules eliminate the exceptions for "broadly-based" plans. NASDAQ further eliminated an exception for plans involving *de minimis* share amounts. Furthermore, prior to the NYSE rules changes, plans that allowed granting of no more than one percent of a company's outstanding common stock to officers or directors and granting of no more than five percent under all of the company's plans did not require stockholder approval. The new rules have removed these exclusions. If a plan limits ownership, it still needs stockholder approval unless it specifically falls under one of the listed exceptions. In addition, the new rules eliminate exemptions for issuances of treasury shares under a plan.

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While the NYSE and NASDAQ amended rules together have the same end goal, the language of the rule changes is not exactly the same. Furthermore, the rule changes will be interpreted and administered by two separate entities. Companies should carefully review existing and proposed plans and amendments to determine if stockholder approval is or will be required and what other approvals and notifications will be necessary. If you have any questions regarding NYSE and NASDAQ rule changes, please contact the lawyer at ZAG/S&W LLP with whom you regularly consult, or the lawyer below.

Howard E. Berkenblit  
(617) 338-2979

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