Equity Compensation — New Ground Rules For Shareholder Approval

I. Introduction

The New York Stock Exchange, Nasdaq and the Internal Revenue Service have recently issued new rules dealing with shareholder approval of equity compensation plans. These new rules require shareholder approval of all equity compensation plans, with limited exclusions, and will change how such arrangements are designed and operated.

II. New Shareholder Approval Requirements for NYSE and Nasdaq Companies

A. Overview

Historically, both the NYSE and Nasdaq have required shareholder approval for most stock option and equity compensation plans. However, exceptions to these general rules enabled companies to adopt certain plans without a shareholder vote. Under guidance from the SEC, the NYSE and Nasdaq have each adopted new rules that require a shareholder vote on virtually all new plans or programs (including individual employment agreements) under which securities may be granted to employees, directors or other service providers, and on material modifications of existing plans and programs. However, there are some substantive differences between the NYSE and Nasdaq approaches, as well as procedural differences, mainly relating to effective dates and transition periods.

Exceptions. Unlike prior NYSE and Nasdaq rules, the new rules have no exceptions for “broad-based plans,” “treasury share plans” and “de minimis grants.” Among the few plans and arrangements that now are exempt from the shareholder-approval requirements are:

- plans that pay all benefits in cash (even if the amount paid is based on stock value, such as stock appreciation rights, known as SARs, and some deferred compensation plans);
- certain awards in the merger and acquisition context;
- tax-qualified plans such as 401(k) plans, ESOPs and employee stock purchase plans;
- certain non-qualified plans that provide benefits in excess of those provided under a tandem qualified plan after application of Internal Revenue Code limits; and
- inducement awards for prospective new hires.

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1 The NYSE rule is at Section 303A(8) of the Listed Company Manual and Rule 452, and the Nasdaq rule is at NASD Rule 4350(i) and IM 4350-5. The SEC approved the new rules in Release No. 34-48108. A 21-day comment period on the new rules expired on July 24. The SEC has not indicated whether — or when — any changes might be made in response to the comments. The Nasdaq, on August 15, 2003, proposed changes to the Nasdaq rule, which the SEC has not yet approved.
In lieu of shareholder approval, the issuer’s compensation committee or a majority of the issuer’s independent directors must approve tax qualified plans, non-qualified plans and inducement awards under both the NYSE and Nasdaq rules and also awards in the merger and acquisition context under the NYSE rule. A NYSE company also must notify the NYSE in writing whenever it relies on an exception that requires such approval.

In addition, plans that are available to shareholders generally (such as dividend reinvestment programs) or that merely afford a convenient means of purchasing stock at fair market value also are exempt from the new rules.

**Material Amendments.** The new rules also require shareholder approval of material amendments to an equity compensation plan. The requirement expressly applies to amendments that:

- materially increase the number of shares available under the plan (other than as a result of reorganizations, stock splits and similar events);
- expand the types of awards available under the plan;
- materially broaden the class of individuals eligible to participate in the plan;
- materially extend the term of the plan;
- materially change the method of determining the exercise price of options (under the NYSE rule);
- materially reduce the minimum exercise price for which options may be granted (under the Nasdaq rule); or
- permit option repricing. Under the NYSE rule, any repricing will be considered a material amendment requiring shareholder approval unless the plan explicitly permits repricing.

The NYSE rule specifies that any amendment that curtails the scope of a plan will not require shareholder approval. Although not explicitly stated, the Nasdaq rule presumably could be interpreted to reach the same result.

Under the Nasdaq (but not the NYSE) rule, a plan can expressly authorize future specific amendments without further shareholder approval, but cannot grant general amendment power. Although this provision appears to permit a plan to authorize Board-only approval of all of the categories of amendments that the Nasdaq rule identifies as material, Nasdaq staffers have indicated that they interpret this provision more narrowly, and that specific amendment language in a plan should not be relied upon to permit Board-only approval of increases in the number of shares available for grant.

**Broker Voting.** The NYSE rule expressly precludes broker discretionary voting on equity compensation plans; the beneficial owner must specifically direct the vote. As the conventional wisdom is that brokerage houses often vote for management proposals, this provision may make it significantly more difficult to obtain shareholder consent. Moreover, with the recently enacted SEC requirement that mutual funds disclose their votes, once safe “yes” votes may be at further risk. These provisions will increase the power that large institutional investors wield over the terms of such plans. This change conforms the NYSE rule to the Nasdaq, which already precludes broker discretionary voting.

### B. Application to Specific Situations

**Discretionary plans.** In the case of plans (referred to in the new rules as “discretionary plans”) that neither limit the number of shares available for grant nor provide solely for
specific pre-determined grants, such as annual grants to directors, each individual grant must have shareholder approval.\(^2\)

**Evergreen and Formula plans.** Plans that provide for automatic increases in the number of shares available ("evergreen plans")\(^3\) and plans that do not limit the number of shares available but provide for specific pre-determined grants ("formula plans")\(^4\) are limited to plan terms of ten years. If the plan term exceeds ten years:

- Under the NYSE rule each increase of the share amount under the evergreen plan, and each grant under the formula plan, will require shareholder approval. However, grants can continue to be made without shareholder approval from the number of shares authorized under an evergreen plan as of June 30, 2003.

- The Nasdaq rule appears to provide that the plan can be operated for the first ten years, after which it will need additional shareholder approval. However, the SEC release describes the Nasdaq rule as conforming to the NYSE rule, seemingly interpreting it to require shareholder approval even during the initial ten-year period for each increase of the share amount under the evergreen plan and each grant under the formula plan.

Under the NYSE rule, which treats restrictive amendments as non-material, an evergreen or formula plan can be "fixed" without going back to shareholders by an amendment limiting the plan to a 10-year term (assuming that the plan permits such an amendment). Although the Nasdaq rule does not explicitly consider all restrictive amendments to be non-material, Nasdaq staffers have indicated that an amendment limiting the plan to a 10-year term would be considered non-material.

**NYSE Transition period for discretionary, evergreen and formula plans.** The NYSE (but not the Nasdaq) rule includes a transition period for discretionary, evergreen and formula plans that would otherwise require shareholder approval of each grant or share increase. These plans can continue to operate in the normal course without shareholder approval until June 30, 2004 or, if earlier, the first annual shareholder meeting at which directors are elected after December 27, 2003.

**Qualified plans.** The rules provide an alternative procedure with regard to approval of qualified plans (such as 401(k) plans and ESOPs) that allocate company stock to participants’ accounts; the compensation committee or a majority of the independent directors may approve such plans (or amendments) in lieu of shareholders. This alternative approval procedure may require changes to plans that by design or operation permit amendments to be adopted without Board action. It should be noted that the new rules do not distinguish material amendments that affect the employer stock features of such plans from those that have no direct impact on how or to what extent stock is acquired. Nasdaq listed companies could provide in the plan document that certain types of future amendments, such as amendments necessary to reflect changes in law, are to be made by the plan administrator (or other delegatee), thereby avoiding the shareholder (and alternative Board) approval

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\(^2\) Under the NYSE rule, plans that are bifurcated, providing for certain grants without a maximum share limit and for other grants with a maximum share limit, can be viewed as two separate plans, with non-shareholder approved grants continuing to be made under the portion of the plan that includes a maximum limit. Arguably, the same should be true for a plan without a maximum share limit that provides for both formula grants and non-formula grants, but the rule does not address that situation.

\(^3\) As discussed below, under the IRS proposed regulations, incentive stock options will no longer be permitted to be included as part of “evergreen” plans.

\(^4\) The Nasdaq rule only refers to dollar-based formula grants.
requirement for such amendments. For changes that cannot readily be anticipated by Nasdaq companies, and for NYSE companies generally, it appears that material amendments to such plans will have to be approved by the compensation committee or a majority of the independent directors. Companies should consider whether the amendment provisions of their plan documents need to be revised to reflect these new requirements.

**Nonqualified deferred compensation.** Both the NYSE and the Nasdaq rules exempt from the new shareholder-approval requirements plans that provide benefits parallel to a qualified plan in excess of applicable Internal Revenue Code limits. However, under both rules the exception is limited to plans with substantially the same terms as the related qualified plan and that cover all participants in the related qualified plan who have compensation in excess of the Code section 401(a)(17) limit (currently $200,000). As a practical matter, many nonqualified plans do not operate strictly “in tandem” with a qualified plan. Plans that fail to satisfy the parallel-plan exception will fall into the category of discretionary plans, as they generally lack maximum share limits and 10-year terms, and will require shareholder approval of each stock grant. Given the impracticalities of that result, sponsors may opt to eliminate the stock payment feature from nonqualified deferred compensation plans, thus removing them from operation of the new requirements.

**Stock Option Repricing.** The NYSE and Nasdaq have maintained somewhat different approaches to stock option repricings.

- Under the NYSE rule, repricing an option (or canceling an option and replacing it with another) will require shareholder approval unless the plan terms expressly and explicitly permit repricing. Plans without express, explicit repricing authorization language will be deemed to prohibit repricings. Moreover, any amendment to permit repricing is deemed material, thereby requiring shareholder approval.

- Under the Nasdaq rule, repricing an option will require shareholder approval only if the plan terms prohibit repricing. If the plan does not prohibit repricing (e.g., by being silent on the issue), shareholder approval is not required. However, an amendment that permits repricing is deemed material, thereby requiring shareholder approval. Although the Nasdaq does not require an explicit reference to repricing to permit it, the Nasdaq “recommends that plans meant to permit repricing use explicit terminology to make this clear.”

**Employment Inducement Awards.** Equity awards to prospective employees as an inducement to accept employment (or to accept re-employment after a “bona fide” termination) do not require shareholder approval, so long as the compensation committee or a majority of the independent directors approves the grants. In addition, under the NYSE rule, the company must issue a press release describing the material terms of the award, including the name of the recipient and the number of shares involved. The Nasdaq has proposed amending its rule to include this disclosure requirement as well.

We understand from discussions with Nasdaq staffers that this exception is only intended to apply to awards outside of a plan, a position that is supported by a literal reading of both the NYSE and the Nasdaq rules, which refer to employment inducement grants and not to a plan. In view of the Nasdaq’s position and the possibility that the NYSE might concur, an employer that does not want to deplete a shareholder-approved plan with employment...
inducement awards should consider granting those awards outside of the plan, and not assume that it can increase plan limits to cover such grants without shareholder approval.  

**Mergers and Acquisitions.** Both the NYSE and the Nasdaq rules include three basic exceptions to the shareholder-approval requirement in M&A situations:

- First, any new employees employed in connection with the transaction are included in the employment inducement exception.
- Second, options of the target company can be adjusted, replaced or converted without requiring any further shareholder approval. The NYSE rule permits this even if an underwater target company option is replaced with a fair market value acquirer option, effectively resulting in a repricing.  
- Finally, if the target company had any equity compensation plans that were approved by its shareholders, the acquiring company can use the shares (adjusted to reflect the transaction) reserved under those plans for post-transaction grants under those plans or any other plan (but only during the time period established under the original target company plan). However, options or other awards related to those shares can only be granted to target company employees who transferred to the acquiring company in connection with the transaction, and cannot be granted to individuals who were employees of the acquiring company immediately prior to the transaction.  

**C. Interpretive Guidance**

In view of some of the uncertainties under the new rules, employers may wish to consider requesting interpretive guidance from the NYSE or the Nasdaq. We understand from Nasdaq staffers that at the present time, interpretive letters are being issued within four weeks of the date the request is received.

**D. Effective Date**

The new shareholder-approval requirements generally became effective June 30, 2003, except that:

- The NYSE ban on broker voting only became effective for shareholder meetings held on or after September 28, 2003; and
- The NYSE rule provides a limited transition period for evergreen, formula and discretionary plans, as described above.

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6 However, granting equity awards outside of the plan has two drawbacks:

1. The awards will have to be separately registered on a Form S-8; the S-8 filed for the plan will not apply to non-plan awards.
2. Non-plan options will be subject to the deduction limitations of Code Section 162(m). The exemption that is generally relied upon only applies to grants under a shareholder-approved plan. (In any event these grants will not qualify as incentive stock options since the shares subject to the grants were not approved by shareholders.)

7 Under the NYSE rule, the shares subject to these options will be counted towards the 20% threshold to require shareholder approval of the transaction.

8 Under both the NYSE and the Nasdaq rules, the shares subject to these plans will be counted towards the 20% threshold to require shareholder approval of the transaction.

9 It is not entirely clear if new employees of the combined companies, hired after the transaction, could receive awards related to such shares. The language of both the NYSE and the Nasdaq rules indicates that they could, but the explanation to the Nasdaq rule in the SEC Release states that the options must be given to individuals who were employees of the target company immediately prior to the transaction.
III. Proposed ISO Regulations

On June 6, 2003 the Internal Revenue Service released long-awaited proposed regulations dealing with incentive stock options (ISOs). These proposed regulations, which replace proposed regulations previously issued in 1984, primarily restate existing guidance, but also add some significant new rules.

A. Significant Changes Affecting Common Design Features

The ISO rules have always required shareholder approval of the maximum number of shares that could be granted as ISOs. The proposed regulations impose new requirements for satisfying this basic rule.

- **Maximum number of shares.** It had previously been accepted that a plan that included other forms of stock grants in addition to ISOs could satisfy the shareholder-approval requirement even if non-ISO grants had flexible limits (e.g., an “evergreen” provision), so long as a specific sub-limit applied to ISO grants. Accordingly, it is not unusual to see “omnibus” plans that include a variety of equity awards that are granted under evergreen provisions, with only the ISO grants subject to a specific limit. Under the new proposed regulations, the requirement of a maximum share cap must apply to the entire plan (although different types of grants can have different limits). Thus, a plan that provides for the grant of ISOs cannot include an evergreen provision, even where the evergreen provision applies only to non-ISO grants.

- **Share counting methods.** The manner in which shares are counted for purposes of determining the maximum number of shares that can be granted under a plan can have a significant impact on how fast the available pool of shares is exhausted. To lengthen the expected life of a plan, some plans provide for the available pool to be replenished with any shares that are re-acquired by the issuer through transactions under the plan (such as shares used to pay the exercise price or to satisfy tax withholding). Under the new proposed regulations the only shares that can be “added back” to the available pool are
  - shares that are not ultimately issued (because the option is not exercised),
  - shares that are issued but are forfeited under the terms of the plan, and
  - shares that are voluntarily surrendered to the company as payment of the exercise price (i.e., excluding shares withheld for tax purposes).

*Effective date.* The original proposed regulations on ISOs have been withdrawn and employers may rely on the new proposed regulations for ISOs granted after June 9, 2003. Since the new proposed regulations do not include a transition period for existing plans, it is unclear whether ISOs can continue to be granted under plans that do not comply with them. Hopefully, the IRS will recognize the need for transition relief for plans previously approved by shareholders with provisions that do not comply with the new rules.

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10 Proposed Treasury Regulation §§1.421, 1.422, 1.424. The IRS accepted written comments until August 12, 2003 and held a public hearing on September 2, 2003. It is difficult to predict when final regulations will be issued, but the IRS seems to be focused on seeing this matter through.
In the interim, employers might want to consider amending plans to delete the offending provisions, if the plans contain appropriate amendment language. Arguably, such amendments will be valid even without shareholder approval since they will effectively reduce limits already approved by shareholders.

B. Other Clarifications

In addition to the points noted above, the new proposed regulations include the following changes:

- **Electronic documentation.** Both the stock option plan and the ISO grant agreement may be in electronic form, provided that they are legally binding under applicable law.

- **Corporate employer requirement.** ISO grants are available solely to “employees of corporations”; this has been clarified so as to expressly include employees of Subchapter S corporations, foreign corporations and LLCs treated as corporations for federal tax purposes.

IV. Conclusion

These developments will certainly affect the terms of new equity compensation plans and will likely require changes in existing plans. By broadening the types of arrangements requiring shareholder approval, the new NYSE and Nasdaq rules will likely increase the ability of large (generally institutional) shareholders to influence the terms of these plans.

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