NYSE ALERT: NEW CORPORATE GOVERNANCE STANDARD REQUIRING SHAREHOLDER APPROVAL OF EQUITY COMPENSATION PLANS

ALVIN BROWN, KENNETH C. EDGAR, JR. , STEPHEN W. FACKLER,
BRIAN D. ROBBINS & FRANCIS C. MARINELLI
SIMPSON THACHER & BARTLETT LLP

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As we have previously written in several memoranda,[1] the New York Stock Exchange has filed with the Securities and Exchange Commission, as part of its new Corporate Governance Proposals, a rule proposal that would generally require shareholder approval of all equity compensation plans. Amendments to the rule proposal were filed by the NYSE with the SEC on November 6, 2002 and most recently on June 20, 2003.

The SEC approved the rule proposal, as amended, on Monday, June 30, 2003. This memorandum summarizes the material features of the rule proposal as approved.[2]

SUMMARY OF THE NYSE SHAREHOLDER APPROVAL LISTING STANDARD

The primary thrust of the approved rules is to change the listing standards for companies listing their shares on the NYSE. The general rule for NYSE listed companies is that shareholders must approve all equity-compensation plans and material revisions to such plans.

[1] Further information regarding this shareholder approval rule proposal can be found in our August 23, 2002 memorandum entitled *"NYSE Board of Directors Approves New Corporate Governance and Disclosure Standards"*, our October 22, 2002 memorandum entitled *"NYSE Clarifies New Corporate Governance Standard Requiring Shareholder Approval of Equity Compensation Plans,"* (the "October 22, 2002 Memorandum") and our November 4, 2002 alert entitled, "*New York Stock Exchange Governance Proposals: Shareholder Approval of Equity Compensation Plans Alert."* Copies of these documents are available upon request or at our website: *www.simpsonthacher.com*.

[2] The recently approved NYSE Rule does not apply to the equity-compensation plans of listed non-U.S. issuers, as long as such entities comply with the requirements of Section 303 of the NYSE Listed Company Manual. Section 303 of the NYSE Listed Company Manual requires a non-U.S. issuer to certify that it complies with its home country practices regarding corporate governance.

The general rule is extremely broad in scope. The term "equity-compensation plan" covers grants of all the standard types of stock awards which companies use to selectively motivate their officers, directors and key employees. It covers stock options, restricted stock awards, and stock purchase rights. It covers not only written plans, but also individual arrangements and informal policies which are not described in a formal written plan document. It covers issuances of both newly issued shares and treasury shares.[3] It covers stock awards to any class of person as compensation for services, encompassing consultants, advisors and independent contractors as well as employees and directors.

This definition is subject to a number of exceptions. First, plans made available to all shareholders generally, such as dividend reinvestment plans, are not included. Second, purchases by a service provider at the then prevailing fair market value for the shares are not included, regardless of whether the purchase is on the open market or from the company. Third, a stock award made to induce a person to accept employment is not included. Fourth, in the context of mergers and acquisitions, stock plans and outstanding stock awards of an entity which are converted into shares of the listed company are not included, subject to some limitations on post-transaction awards. Finally, certain types of retirement plans and employee stock purchase plans which mandate broad participation and/or limited benefits are not included. These exceptions are discussed in further detail in the body of this memorandum.

Transition rules are provided for obtaining shareholder approval for certain types of plans which previously did not require such approval, even if the plan is not materially revised. The most significant type of plan subject to these transition rules is the so-called "evergreen" plan, which contains a formula for automatic increases in the number of shares available.

The definition of a "material revision" has deliberately been left open ended. The approved rules and accompanying commentary provide a non-exclusive list of such revisions, including a material increase in the plan's share reserve, a material extension in eligible participants, and an expansion in the types of awards available under the plan. Option repricing is treated especially strictly, so that any plan which does not specifically permit repricing will be considered for purposes of the listing standard as prohibiting repricing. Therefore any option repricing under such a plan (including an exchange of an option for another option, restricted stock or other equity--but not cash) requires shareholder approval. The rules as approved do not establish a standard to assist with a determination as to whether or not a revision is "material".

The approved rules also provide that a broker would no longer be permitted to vote a customer's shares on any equity compensation plan unless the broker has received that customer's instructions to do so (previously, a broker could vote by proxy those shares it held

[3] In addition, the NYSE has expressly noted that its traditional "treasury share exception," under which shareholder approval was not required to reissue shares of stock that had been reacquired by the company, is no longer available.

for the account of others if it did not receive voting instructions from the beneficial owner and was not aware of any matter contested at the meeting). This rule will apply to meetings of shareholders of NYSE listed companies occurring on or after September 28, 2003. The NYSE will establish a working group to advise it on the need for possible mechanisms to facilitate this new rule, although this recommendation will not delay the effectiveness of the new rule.

FURTHER DETAIL

The new NYSE rule related to shareholder approval of equity compensation plans is codified at Section 303A(8) of the NYSE Listed Company Manual. The basic principle of the new rule is stated as follows:

> **Shareholders must be given the opportunity to vote on all equity-compensation plans and material revisions thereto, with limited exemptions explained below.**

In order to facilitate the understanding of the basic principle stated above, the new rule contains additional text to address specific issues that arise under the new rule. The additional guidance is summarized below.

DEFINITION OF "EQUITY-COMPENSATION PLAN"

The rule provides that an "equity-compensation plan" is 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. An arrangement that provides an employee, director or other service provider with a cash payment, however, would not be subject to the rule since it does not involve the delivery of shares to a service provider. A compensatory grant of options or other equity securities that is not made under a formal plan is, nonetheless, an equity compensation plan for these purposes. As a result, even the grant of an option to a single existing employee, pursuant to a resolution of an issuer's board of directors, would be subject to the rule's shareholder approval requirement, absent an exemption.

Plans which merely provide employees, directors or service providers a convenient way to buy shares on the open market or from the issuer *at fair market value*, are not equity compensation plans under the rule, regardless of whether (i) such shares are delivered immediately or on a deferred basis, or (ii) whether the service providers pay for the shares directly or by giving up compensation that is otherwise due (e.g., via payroll deductions). This exemption is valid even if the listed company pays for the brokerage and other costs of maintaining the plan. It would also appear that a mere deferral of compensation into restricted stock units (ultimately payable in shares) on a fair market value basis is exempt from shareholder approval. Further, shareholder approval is not required for plans that are made available to shareholders generally (such as typical dividend reinvestment (DRIP) plans).

MATERIAL REVISIONS TO PLANS

Any "material revision" to the terms of an equity-compensation plan will be subject to shareholder approval.

A "material revision" includes, but is not limited to, a revision that:

- materially increases 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);
- expands the types of awards available under the plan;
- materially expands the class of persons eligible to receive awards under or otherwise to participate in the plan;
- materially extends the term of the plan; or
- materially changes the method of determining the exercise price (the "strike price") of options under the plan.[4]

Special Rule for "Formula Plans"

A "formula plan" is a plan that contains a formula for automatic increases in the shares available (frequently referred to as an "evergreen" plan) or that automatically grants stock awards pursuant to a formula. Formula plans require shareholder approval for each such increase or grant unless the plan is limited to a specified term of not more than ten years. Evergreen plans (regardless of term) are one common type of formula plan. Other examples of formula plans are (1) annual grants to directors of restricted stock having a certain dollar value, and (2) plans involving matching contributions, under which stock is credited to an individual's account based upon the amount of compensation the individual elects to defer.

Special Rule for "Discretionary Plans"

The rule also addresses "discretionary plans", which are defined as plans that do not expressly limit the number of shares available for grant.[5] Each grant under a discretionary plan requires separate shareholder approval, regardless of whether the plan has a term of not more than ten years.

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[4] The rule expressly states that the NYSE would not view as material 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 that date.

[5] The NYSE expressly notes that a requirement that share 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".

Repricing

A plan that does not by its express terms permit the repricing of options will be considered as prohibiting repricing. Therefore, any repricing of options granted under a plan which does not expressly permit repricing will be considered a "material revision" under the rule, even if the plan itself is not modified. The rule clarifies that repricing through an exchange offer commenced prior to the rule's effectiveness would not be subject to shareholder approval (assuming that such a program did not require shareholder approval under the NYSE rules prior to June 30, 2003). "Repricing" for this purpose means any of the following (or any other action that has the same effect as any of the following actions):

- amending the terms of an option after it is granted to lower its strike price;
- any action that is treated as a "repricing" under generally accepted accounting principles; and
- canceling an option at a time when its strike price is equal to or less than the fair market value of the underlying stock, in exchange for another option, restricted stock or other equity award, unless the cancellation and exchange occurs in connection with a merger, acquisition, spin-off or other similar transaction.

EXEMPTIONS

The rule provides the following exemptions from the shareholder approval requirement:

- Employment inducement awards
- Plans relating to mergers or acquisitions
- Tax-qualified plans, "parallel excess plans" and Section 423 plans

These exempt grants and plans may only be made or adopted with compensation committee approval or approval of the majority of the listed company's independent directors. The rule requires an issuer to notify the NYSE in writing whenever it takes advantage of one of the foregoing exemptions. A summary of the exemptions contained under each of the headings is set forth below.

Inducement Awards

An "inducement award" (i.e., an award of options or other equity as a material inducement to a person being hired) is exempt from shareholder approval. (Note that under preliminary versions of the rule, it appeared that the term "employment inducement awards" only covered grants of options or shares as a material inducement to a person *first* becoming an employee of the issuer or one of its subsidiaries. The final rule, however, clarifies that former employees rehired following "a bona fide period of interruption of employment" can qualify for "employment inducement awards".) Inducement awards include grants to new employees in

connection with a merger or acquisition. Inducement awards to other types of service providers, in particular potential candidates to serve on a listed company's board of directors, are not covered by this exemption.

Promptly following the grant of an inducement award under this exception, the listed company must issue a press release that discloses the material terms of the award, including the recipient(s) of the award and the number of shares involved.

Plans Relating to Mergers or Acquisitions

Two different categories of plans are also expressly exempt from the rule.

1. Shareholder approval is not required to convert, replace or adjust outstanding options or other equity compensation awards to reflect a corporate merger or acquisition.

2. Shares available under certain plans acquired in corporate mergers and acquisitions may be used for some post-transaction grants without further shareholder approval. [6]

The second exception applies to situations where the company that is not a listed company following the transaction (e.g., the privately held subsidiary of a publicly traded acquiror, whether or not the shares of the subsidiary were publicly traded prior to the merger or acquisition) has shares available for grant under pre-existing plans that were previously approved by its shareholders. These shares (after having been converted to shares of the listed company as a part of the transaction) could be used for post-transaction grants of options and other equity 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 they would have been available under the pre-existing plan, absent the transaction; and

[6] Any shares reserved by the listed company to satisfy outstanding stock awards and assumed share reserves of a pre-existing plan will be included in determining whether the merger or acquisition transaction involves the issuance of 20% or more of the listed company's outstanding common stock. If so, then under other NYSE rules relating to shareholder approval, the shareholders of the listed company must approve the merger or acquisition transaction.

- those options and other awards are not granted to individuals who were employed by the issuer (i.e., the acquiror) or any of its subsidiaries at the time the merger or acquisition was consummated.

For the purposes of this exception, the NYSE would not view a plan adopted in contemplation of the merger or acquisition transaction as "pre-existing."

Tax-Qualified Plans, "Parallel Excess Plans" and Section 423 Plans

The rule specifically excludes the following types of plans from the shareholder approval requirement:

- Plans intended to meet the requirements of Section 401(a) of the Internal Revenue Code (i.e., tax-qualified retirement plans such as ESOPs and 401(k) Plans)

- Employee Stock Purchase Plans (ESPPs) intended to meet the requirements of Section 423 of the Internal Revenue Code[7] (note that the Internal Revenue Code already requires that Section 423 plans receive shareholder approval)

- Parallel excess plans

The rule clarifies that "parallel excess plans" are pension plans that are subject to the Employee Retirement Income Security Act of 1974 ("ERISA") designed to work in parallel with a related tax-qualified plan to provide benefits that exceed certain specific limitations on benefits imposed by the Internal Revenue Code on tax-qualified plans.[8] A plan only may be a parallel excess plan if it covers substantially all employees who participate in the underlying tax-qualified plan but whose annual compensation exceeds the applicable IRS limits (currently $200,000) on compensation that may be taken into account under a tax-qualified plan.

TRANSITION RULES

The rule clarifies when shareholder approval is required for plans adopted before June 30, 2003. The general rule provides that a plan adopted before June 30, 2003, will not be subject to shareholder approval under the new rule unless and until it is materially revised.

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[7] An employee stock purchase plan that provides non-U.S. employees with substantially the same benefits as a Section 423 plan provides to the same company's U.S. employees, but with features necessary comply with applicable foreign tax law, are also exempt from shareholder approval under this rule.

[8] The specific limitations mentioned in the rule are (1) IRC Code Section 402(g), which limits an employee's pre-tax contributions to a 401(k) plan, (2) IRC Code Section 401(a)(17), which limits the amount of an employee's annual compensation which can be taken into account for calculating benefits, and (3) IRC Code Section 415, which limits annual contributions or benefit accruals.

In the case of a plan that is a "discretionary plan" adopted prior to June 30, 2003, whether previously approved by shareholders or not, additional grants are allowed after June 30, 2003, without further shareholder approval only for a limited transition period (described below), and then only in a manner consistent with past practice. If a plan can be separated into a discretionary and non-discretionary portions, the discretionary portion would be subject to the transition period, while the non-discretionary portion would benefit from the general rule that shareholder approval is only required upon subsequent material revision.

In the case of a "formula plan" adopted prior to June 30, 2003, that either (1) has not previously been approved by shareholders or (2) does not have a term of ten years or less, additional grants are allowed after June 30, 2003, without shareholder approval only for the limited transition period.

A shareholder-approved "formula plan" may continue to be used after the end of the transition period if it is amended to provide for a term of ten years or less from the date of its original adoption or, if later, the date of its most recent shareholder approval. Such an amendment may be made before or after June 30, 2003, and would not itself be considered a "material revision" requiring shareholder approval.

In addition, a formula plan may continue to be used, without shareholder approval, if the grants after June 30, 2003, are made only from the shares available immediately prior to June 30, 2003 (i.e., shares reserved for issuance under the plan based upon formula increases that occurred prior to June 30, 2003).

The "transition period" for these purposes commenced on June 30, 2003, and ends on the first to occur of any one of the following events:

- 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.

Broker Voting

For meetings of shareholders of a listed company which occur on or after September 28, 2003, under amended Rule 452 of the NYSE Constitution and Rules, brokers are not permitted to vote a client's shares on any equity compensation plan matter unless the client has given the broker voting instructions.

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Please contact your relationship partner or Alvin Brown (abrown@stblaw.com, 212-455-3033), Kenneth C. Edgar, Jr. (kedgar@stblaw.com, 212-455-2560), Stephen W. Fackler (sfackler@stblaw.com, 650-251-5170), Brian D. Robbins (brobbins@stblaw.com, 212-455-3090) or

Francis C. Marinelli (fmarinelli@stblaw.com, 212-455-2661) if we can be of assistance regarding these important developments.

SIMPSON THACHER & BARTLETT LLP