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

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On October 7, 2002, the New York Stock Exchange filed with the Securities and Exchange Commission an amended rule proposal relating to shareholder approval of equity compensation plans. The new filing clarifies the meaning of the NYSE's original proposal, which is part of the NYSE's Corporate Governance Proposals for new listing standards regarding corporate governance and disclosure filed with the SEC on August 16, 2002. All of the Corporate Governance Proposals are discussed in our more comprehensive August 23, 2002 memorandum entitled *"NYSE Board of Directors Approves New Corporate Governance and Disclosure Standards"* (the "August 23rd Memorandum"). Additional copies of the August 23rd Memorandum are available upon request or at our website: *www.simpsonthacher.com*.

Among other things, these new clarifications:

- expand considerably the situations in which equity compensation plans are considered to be materially revised, and therefore require new shareholder approval, including any changes relating to "repricing" of options;

- provide that any actual "repricing" – more broadly defined than under accounting rules – would itself, unless it is specifically permitted by the applicable plan, be considered a material revision of the plan, requiring shareholder approval; and

- limit the grandfathering of unapproved existing plans with "evergreen" formulas (which provide for automatic increases in the number of shares available under a plan).

Unless extended, the deadline for SEC action on the proposed shareholder approval standard is November 15, 2002. By this date, the SEC must either approve the proposed new listing standard or institute proceedings to determine whether the proposed rule change should be disapproved. The NYSE has previously stated that the new shareholder approval requirement would become effective immediately upon being declared effective by the SEC.

SUMMARY OF THE PROPOSED SHAREHOLDER APPROVAL LISTING STANDARD

As the NYSE noted in its August 1, 2002 press release announcing its approval of the Corporate Governance Proposals, the proposed new listing standards are aimed at "helping to restore investor confidence by empowering and ensuring the independence of directors and strengthening corporate-governance practices."[1] Among the other proposed changes to the NYSE's listing standards, the Corporate Governance Proposal regarding shareholder approval of equity compensation plans would require that shareholders be given the opportunity to vote on all equity compensation plans other than:

- employment-inducement awards;
- plans acquired through mergers or acquisitions;
- tax-qualified plans (*e.g.*, ESOPs and 401(k)s); and
- "parallel nonqualified plans" (*i.e.*, plans that are maintained solely to provide contributions and benefits in excess of the limits imposed by the tax code).[2]

Accordingly, the new listing standard would eliminate the NYSE shareholder approval exemption for broad-based equity compensation plans.[3] The requirement for shareholder approval would extend as well to material revisions to the terms of equity compensation plans.

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1 The Corporate Governance Proposals would apply to all companies listing common stock on the NYSE, with special rules applicable to foreign private issuers. See the discussion below under the caption "Foreign Private Issuers."

2 The original rule proposal limited such plans to "excess benefit plans," but the amended proposed rule as expanded the applicability of the exception. See the discussion below under the caption "Exceptions from Applicable 'Equity Compensation Plans' – Tax Qualified Plans and 'Parallel Nonqualified Plans.'"

3 In addition, the new listing standard expressly notes that the NYSE's 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.

The Corporate Governance Proposals 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 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). 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.[4]

The proposed rule regarding shareholder approval of equity compensation plans was refiled as a separate rule proposal at the request of the SEC to facilitate SEC handling of the proposal separately from the other Corporate Governance Proposals. In refiling the proposal, the NYSE amended the proposal to clarify its meaning in several respects.

CLARIFICATIONS OF THE ORIGINAL PROPOSED RULE

All of the Corporate Governance Proposals, including the proposed rule on shareholder approval of equity compensation plans, are presented in a format where a basic principle is expressed, followed by additional explanation and clarifications captioned as "commentary." The NYSE has stated that, in setting forth the proposals in this format, it is articulating a philosophy and approach to corporate governance that companies and their boards are expected to apply the requirements carefully and in good faith, making reasonable interpretations as necessary as they apply the requirements to the specific facts and circumstances that they confront from time to time, *and disclosing the interpretations that they make*.[5]

The following changes and clarifications were made in the amended rule proposal:

EXCEPTIONS FROM APPLICABLE "EQUITY COMPENSATION PLANS"

The amended rule proposal clarifies that, for purposes of the shareholder approval rule, "equity compensation plans" would not include plans that are made available to shareholders generally (such as typical dividend reinvestment (DRIP) plans) or plans that merely provide a

[4] The amended shareholder approval rule proposal does not alter the original proposal regarding broker votes.

[5] It is unclear what form this disclosure of companies' interpretations would take, or in what context disclosure would be made.

convenient way for employees, directors or service providers to buy shares on the open market or from the issuer (such as through payroll deductions).[6]

Furthermore, the original proposed rule set forth four exceptions to the requirement that shareholder approval be obtained for all equity compensation plans -- inducement awards, plans relating to mergers or acquisitions, tax qualified plans and excess benefit plans. The amended rule proposal clarifies each of these exceptions.

Inducement Awards

The amended rule proposal clarifies that the term "employment inducement awards" is intended to cover only grants of options or shares as a material inducement to a person's *first* becoming an employee of the issuer or one of its subsidiaries.[7]

While obviously intended to exclude awards granted to existing employees, this language would appear also to exclude an award used as an employment inducement in the case of rehiring someone who had been an employee of the issuer or one of its subsidiaries at some point in the past, even though there is no compelling rationale for treating an employment inducement to former employees differently. In addition, it is not entirely clear whether grants of options or shares to employees of a "target" company in the context of a corporate merger or acquisition, even if intended as a material inducement to key employees to join the acquiring company, would necessarily qualify as "employment inducement awards" since such persons would already have been employees of a company that, depending on the form of the transaction, may become a subsidiary of the issuer.

Plans Relating to Mergers or Acquisitions

The commentary in the original rule proposal described the exception for plans relating to mergers or acquisitions as option plans acquired in corporate mergers and acquisitions. The amended rule proposal expands the excepted plans to cover two different categories of plans.

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6 Such stock purchase plans would not be considered "equity compensation plans" for these purposes even if the brokerage and other costs of the plan are subsidized by the company. If, however, employees, directors or service providers pay less than fair market value for shares under the plan, then a plan not made available to shareholders generally would be considered an "equity compensation plan."

7 It should be noted that the NYSE's rationale for this exception refers to the impracticality of obtaining a shareholder vote on grants of "options and other equity-based compensation" in the context of inducing a candidate to accept employment.

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

- Shares available under some plans acquired in corporate mergers and acquisitions could be used for some post-transaction grants without further shareholder approval.

The second exception applies to situations where the party that is not a listed company following the transaction has shares available for grant under pre-existing plans that were previously approved by its shareholders. These shares could be used for post-transaction grants of options and other equity awards by the listed company (after appropriate adjustment of the number of shares to reflect the transaction), either under the pre-existing plan or another plan, without further shareholder approval,[8] so long as:

- 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

- those options and other awards are not granted to individuals who were employed by the granting company at the time the merger or acquisition was consummated.

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

While the intent of the limitation on the persons to whom options and other awards may be granted under plans acquired in mergers and acquisitions appears to be a concern that executives of the acquiring company may use acquired plans to increase their own equity-based compensation without seeking shareholder approval, the text of the NYSE's commentary seems to place undue dependence on the form of the transaction. For example, in the case of a so-called "top hat" merger, in which two existing companies become subsidiaries of a third, newly-formed parent company, the commentary would appear to permit shares available under the acquired plans of both previously existing companies to be used for post-merger grants to employees of either company.

Tax Qualified Plans and "Parallel Nonqualified Plans"

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[8] The NYSE notes, however, that any shares available under these plans that are reserved for listing in connection with the transaction would be counted in determining whether the transaction involved the issuance of 20% or more of the listed company's outstanding common stock and thus require shareholder approval under the NYSE's listing standards.

The revised rule proposal clarifies the treatment under Internal Revenue Code and Treasury regulations of the tax qualified plans that would be exceptions to the NYSE's shareholder approval requirement. These plans include:

- Plans intended to meet the requirements of Section 401(a) of the Internal Revenue Code (such as ESOPs and 401(k) plans).

- Stock purchase plans intended to meet the requirements of Section 423 of the Internal Revenue Code. (The Internal Revenue Code already requires that Section 423 plans receive shareholder approval.)[9]

In addition, the original rule proposal provided an exception to the shareholder approval requirement for "excess benefit plans." The amended proposed rule expands this exception to "parallel nonqualified plans," that is, plans designed to work in parallel with a related tax qualified plan to provide benefits that exceed the limitations imposed by the Internal Revenue Code on qualified plans. This new term does not limit the excepted plans to only those intended to meet the requirements for an "excess benefit plan" under the Employee Retirement Income Security Act ("ERISA");[10] however, a plan would not be considered a "parallel nonqualified plan" unless:

- it covers all or substantially all employees of an employer who are participants in the related qualified plan but whose compensation is in excess of the limitations set by Section 401(a)(17) of the Internal Revenue Code (currently $200,000); and

- its terms are substantially the same as the qualified plan that it parallels except for the elimination of the limitations imposed by the Internal Revenue Code on qualified plans.

The proposed limitations on "parallel nonqualified plans," however, may themselves be problematic. First, it is not necessarily clear that all persons who earn

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9 Equity compensation plans that would qualify under either of these two categories (or as "parallel nonqualified plans" as next discussed) but for features necessary to comply with foreign tax law in the non-U.S. jurisdiction in which the employees covered by the plan reside would also be exempt from the NYSE's shareholder approval requirement.

10 An "excess benefit plan" is limited under ERISA to a plan that only provides benefits that, but for the maximum benefit or contribution limits set forth in Section 415 of the Internal Revenue Code, would have been provided through the qualified plan. Thus, the new "parallel plan" concept is a welcome, and necessary, liberalization of the original rule proposal.

over $200,000 may be covered by a nonqualified pension plan.[11] Second, many, if not most, of these nonqualified plans do not closely parallel the qualified plans that they supplement. For example, many of these nonqualified plans include bonuses as eligible compensation on which benefits are based, while the related qualified plan may only base benefits on salary.

MATERIAL REVISIONS TO PLANS

The original rule proposal required that any material revisions to the terms of equity compensation plans would also be subject to shareholder approval. The amended proposed rule clarifies the requirement for shareholder approval in these cases by stating that a "material revision" would include, but not be 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);[12]
- changes 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.[13]

In addition, any revision that deletes or limits the scope of a provision of a plan that prohibits "repricing" of options would be considered a "material revision" for purposes of the rule. If a plan does not contain a provision that specifically permits "repricing" of options, the plan will be considered for purposes of the rule as prohibiting "repricing," and any actual

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11 The provisions of ERISA generally limit participation in nonqualified deferred compensation plans to a "select group" of "highly compensated" or "management" employees, but do not define these terms.

12 An automatic increase in the shares available under a plan previously approved by shareholders pursuant to a formula set forth in the plan (which is frequently referred to as an "evergreen" formula) would not be considered a revision for these purposes if the term of the plan is limited to a specified period of time not in excess of ten years. With regard to previously existing "evergreen" plans, see the discussion below under the caption "'Grandfathering.'"

13 The amended rule proposal provides as an example of a formula change 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.

"repricing" of options will be considered a material revision of the plan, even if the plan itself is not revised.[14] For these purposes, a "repricing" means any of the following (or any other action that has the same effect as any of the following):

- amending the terms of an option after it is granted to lower its strike price;
- any other 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, unless the cancellation and exchange occurs in connection with a merger, acquisition, spin-off or other similar transaction.

A cancellation and exchange described immediately above would be considered 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 GAAP and regardless of whether it is voluntary on the part of the option holder.

This last clarification would appear to subject to shareholder approval the most common forms of option cancellation and regrant previously used to avoid adverse accounting treatment (as a "repricing" under GAAP) – the cancellation of the options followed by new grants more than six months later – since an "exchange" may be considered to have been contemplated at the time of the cancellation of the options.[15] Consequently, if "out-of-the-money" options are canceled, it is not clear at what time in the future new options, restricted stock or other equity can be granted without raising an issue about whether an "exchange" was contemplated.[16]

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[14] The original rule proposal contained a very brief indication that "material revisions" to the terms of plans included the repricing of existing options.

[15] This clarification may present significant practical issues. For example, if prior to the announcement of the amended rule proposal an issuer had agreed with employees to exchange "out-of-the-money" options by canceling their existing options and issuing new options with a strike price equal to the then-current market price market on a date more than six months later (to avoid treatment as a "repricing" under GAAP), under the amended rule proposal, unless expressly permitted by the existing plan, the promised exchange would be considered a "material revision" of the plan, requiring shareholder approval. If the issuer is unable to secure that shareholder approval, it may be forced to choose between violating the NYSE's listing requirements and breaching its obligations to these employees. Indeed, there may be an existing inchoate exchange requiring shareholder approval immediately upon the effectiveness of the new NYSE rules.

[16] The commentary does not clearly differentiate between an "exchange" of awards and a subsequent "replacement" of equity-based incentives for employees. It should also be noted that cash "buyouts" of

"GRANDFATHERING"

The original rule proposal did not expressly grandfather those plans that have not been previously approved by shareholders. The amended proposed rule states, however, that the shareholder approval requirement would be applicable to a plan adopted before the effective date of the new rule only upon any subsequent material revision of the plan.

An exception to this grandfathering is that a plan adopted before the effective date of the new rule that contains an "evergreen" formula rather than setting forth a specific number of shares available under the plan would be required to be submitted to shareholders for approval before the next increase in shares under the formula that occurs on or after the effective date of the new rule, unless the plan (including the "evergreen" formula) was previously approved by the shareholders.

ALTERNATIVE APPROVAL REQUIREMENT

The original rule proposal required that, in circumstances in which equity compensation plans are not subject to shareholder approval, the plans would be required to be subject to the approval of the listed company's compensation committee. The amended proposed rule would permit, as an alternative to action by the compensation committee, approval by a majority of the company's independent directors.

FOREIGN PRIVATE ISSUERS

The amended rule proposal expressly states that the NYSE's practice of permitting listed foreign private issuers to follow home country practices with respect to some corporate governance matters would continue to apply to the shareholder approval requirements discussed in this Memorandum. As under existing rules, the non-U.S. company would be required to provide the NYSE with written certification from independent counsel of the company's country of domicile stating that the company's corporate governance practices comply with home country law and the rules of the principal securities market for the company's stock outside the United States. It should be noted that another of the Corporate Governance Proposals would require that foreign private issuers disclose any significant ways in which their corporate governance practice differ from those followed by U.S. domestic companies under the NYSE's listing standards.

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options would not be deemed to involve a cancellation followed by an "exchange" for purposes of determining whether a "repricing" has occurred under the proposed rule.

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