SEC Approves NYSE and Nasdaq Rule Changes For Shareholder Approval of Equity Compensation Plans

The SEC recently approved new rules of the New York Stock Exchange and the Nasdaq Stock Market that generally require shareholder approval of most equity compensation plans and any material amendments to those plans. A summary of the rules follows.

Definition of Equity Compensation Plans

The NYSE rule defines equity compensation plans as plans or other arrangements that provide for the delivery of equity securities of a listed company to any employee, director or other service provider as compensation for services. The Nasdaq rule covers all stock option or purchase plans and other equity compensation arrangements under which options or stock may be acquired by officers, directors, employees or consultants. Despite the difference in language, the coverage is intended to be the same. The breadth of coverage is such that, for example, even a single award to a current employee would require shareholder approval unless previously approved or grandfathered.

Material Revisions and Amendments

Under the NYSE and Nasdaq rules, material revisions or amendments to equity compensation plans and arrangements include, but are not limited to:

- any material increase in the number of shares available under a plan;
- any expansion of the types of awards available;
- any material expansion in the class of eligible participants; and
- any material increase in benefits, including permitting repricings (or deleting or limiting provisions prohibiting repricings), reducing the price at which shares may be offered and extending the term of a plan.

Under the NYSE rule, a plan not expressly permitting repricing is considered to prohibit repricing. As a result, any option repricing under such a plan would be considered a material revision.

The NYSE rule specifically includes any material change in the method of determining the exercise price of options.

Exemptions

Under the NYSE and Nasdaq rules, the following categories of plans and arrangements do not require shareholder approval:

- *Plans Generally Available to All Shareholders*. Any issuance or plan that is made available on equal terms to all shareholders generally, such as a typical dividend reinvestment plan.

- *Open Market or Issuer Purchase Plans*. Any plan that merely allows purchases on the open market or from the issuer at the current fair market value of the shares.

- *Inducement Awards*. Options or other equity-based compensation granted as a material inducement for a person's first time employment with the issuer (or a subsidiary) or employment following a bona fide period of non-employment.

- *Plans in the Context of Mergers and Acquisitions*.
  - The conversion, replacement or adjustment of outstanding options or other awards to reflect the transaction; and

  - Post-transaction grants under a pre-existing plan of the target company, so long as:

    - the plan was previously approved by the target's shareholders;

    - the number of shares available under the plan is adjusted to reflect the transaction;

    - grants are made prior to the expiration of the existing term of the plan; and

    - grants are made only to persons who were not employed by the acquiring company at the time of the transaction.

- Tax-Qualified and Parallel Nonqualified Plans. Tax-qualified employee benefit plans (e.g., ESOP's and stock purchase plans qualified under Sections 401(a) and 423 of the tax code, respectively) and parallel nonqualified (or excess) plans.

The NYSE and Nasdaq rules place conditions on an issuer's reliance on these exemptions, including obtaining approval of such plans or arrangements by the issuer's independent compensation committee or a majority of the issuer's independent directors.

The conditions to an issuer's reliance on a particular exemption are summarized in Annex A to this Alert, which compares the NYSE and Nasdaq rules.

Formula Plans and Discretionary Plans

The NYSE and Nasdaq rules specifically address the treatment of certain types of equity compensation plans where the pool of shares available is either subject to automatic increase based on a formula (evergreen plans), subject to automatic grants based on a formula or not limited by the terms of the plan. An automatic increase in shares available pursuant to a formula or an automatic grant pursuant to a formula will not be considered to be a material amendment to the plan as long as the plan has a term of no more than ten years. Thus, it appears that a plan that specifies a fixed award each year and has an overall share limit would still need to have a limit of no more than ten years. If a non-formula plan has unlimited shares available for grant, it will be deemed a "discretionary plan" and each individual grant under that plan will require shareholder approval.

Broker-Dealer Voting on Plans

The SEC has also approved a change in NYSE rules to disallow broker discretion to vote on equity compensation plans without client instruction, effective for any meeting of shareholders that occurs on or after September 28, 2003.

Effective Date and Transition Periods

The SEC approved the NYSE and Nasdaq rules on June 30, 2003. An equity compensation plan adopted before June 30, 2003 will not be subject to shareholder approval under the new rules unless and until it is materially revised or amended. The NYSE rule provides for specific transition periods for formula and discretionary plans, as summarized in Annex A to this Alert.

Comparing the NYSE and Nasdaq Rules

Though the NYSE and Nasdaq rules are substantially similar, there are differences. Those differences and the specific features of the rules are set forth in Annex A to this Alert.

Contact Information

If you have any questions or would like to learn more about these rules, please contact your usual legal advisor at Ropes & Gray.