Final NYSE Rules Regarding Shareholder Approval of Equity Compensation Plans

Over the course of the last several months, the New York Stock Exchange (the “NYSE”) and the Nasdaq Stock Market, Inc. (the “Nasdaq”) have proposed broad corporate governance initiatives, including changes to their respective rules regarding shareholder approval of equity-compensation plans. After several iterations, the NYSE distributed its final rules (the “NYSE Rules”) to listed companies on June 20, 2003. The NYSE Rules are substantially similar to the proposed standards published in October 2002, but they have been modified to reflect certain of the concerns raised by commentators and have been recast in plain English. Subject to certain transition rules, the final NYSE Rules are expected to become effective on June 30, 2003.

**Covered Plans**

The NYSE Rules require domestic listed companies to obtain shareholder approval for all equity-compensation plans and any material revisions to such plans, with limited exception. An equity compensation plan is a plan or arrangement that provides for the delivery of equity securities as compensation for services to any employee, director or other service provider – but the NYSE Rules specifically note that compensatory grants that are not made under a “plan” (such as individual awards or stand-alone option agreements) are still subject to shareholder approval. The long standing exception to the shareholder approval requirement for plans that delivered only treasury shares, as well as the exception for “broadly-based” equity compensation plans, have been eliminated.

**Material Revisions**

Plans that were adopted prior to the Securities and Exchange Commission’s (the “SEC”) approval of the NYSE Rules will generally not require shareholder approval unless they are “materially revised”. The NYSE Rules offer a non-exclusive list of those revisions that the NYSE will deem “material” and therefore cannot be effected without shareholder approval. For example, shareholder approval is required for any action that:

- materially increases the number of shares available under the plan (except those made solely to reflect a reorganization, stock split, merger, spin-off or similar transaction). An automatic increase in the number of shares available under a plan pursuant to an “evergreen” formula is not considered a modification under the NYSE Rules so long as the plan term does not exceed ten years;

- expands the types of awards available under the plan;

- materially expands the class of persons eligible to participate in the plan;

- materially extends the term of the plan;

- materially changes the method of determining the strike price of options under the plan, or

- deletes or limits a prohibition on option repricing (or actually reprices options issued under a plan that does not expressly permit repricing, even if the plan itself is not revised).

The NYSE Rules also specifically note that an amendment will not be considered a material revision if it curtails, rather than expands, the scope of the plan. Repricings that have commenced prior to June 30, 2003 will not be subject to shareholder approval so long as such approval was not required under existing rules.

**Transition Rules**

As described above, equity plans that were adopted prior to June 30th will not be subject to the NYSE Rules unless the plans contain certain features.
**Formula Plans.** For previously approved “formula plans” – plans that either contain an “evergreen” formula for automatic increases in the number of shares available for issuance or provide for automatic grants to participants pursuant to a formula – each increase in the number of shares available for grant and each formula grant must be approved by shareholders unless the plan has a term of less than ten years. Additional grants may be made under formula plans that were not approved by shareholders or that have a term in excess of ten years without further shareholder approval only through a limited transition period expiring on the earliest of:

- the listed company’s next annual meeting occurring after December 27, 2003;
- June 30, 2004; and
- the expiration of the plan’s term.

A shareholder approved formula plan may continue to be used after the limited transition period if it is amended to provide for a term of ten years or less from its original adoption, or if later, from the date of its most recent shareholder approval. The NYSE Rules expressly provide that this change would not be considered a material revision requiring shareholder approval and, therefore, it may be made before or after June 30 without losing the benefit of the transition rules. Formula plans may also continue to be used without further shareholder approval to the extent shares are available immediately prior to June 30 (i.e., the formulaic increase in the number of shares is effected prior to June 30).

**Discretionary Plans.** Pre-existing plans that are not formula plans do not designate a specific number of shares for issuance are termed “discretionary plans.” After June 30th, additional grants may be made under discretionary plans without shareholder approval only through the expiration of the limited transition period described above, and then only in a manner consistent with past practice, irrespective of whether the plan was previously approved by shareholders. Discretionary plans with a non-discretionary component may be bifurcated and the non-discretionary portion may continue to be used under the appropriate transition rule. This would be the case where a shareholder approved plan permits both grants pursuant to a provision that designates a specific number of authorized shares, and also permits the use of an unlimited number of treasury shares. In this case, the specifically authorized shares may continue to be used after the transition period in accordance with the general transition rule.

**Plans not Covered**

Certain types of plans are not considered to be equity-compensation plans for purposes of applying the new shareholder approval requirements, such as plans that:

- do not actually deliver equity securities but satisfy awards only in cash, such as cash settled stock appreciation right programs and certain phantom stock plans;
- are made available to shareholders generally, such as dividend reinvestment plans; or
- facilitate the purchase of shares – either on the open market or directly from the listed company – by employees, directors or other service providers, regardless of whether the shares are delivered immediately or on a deferred basis.

The latter two exceptions apply even if the brokerage and other costs of the plan are subsidized by the listing company. If, however, the participants pay less than fair market value for shares under those plans, the plans must be approved by shareholders.

**Exemptions**

Listed companies may avail themselves of one of the following exemptions from the NYSE rules so long as the plan or material revision is approved by the company’s compensation committee or a majority of the independent members of the board. Additionally, companies must notify the NYSE in writing to rely on one of these exemptions.

**Corporate Transactions.** Shareholder approval is not required to convert, replace or adjust equity compensation awards to reflect a merger or acquisition. In addition, shares available under certain plans assumed in mergers and acquisitions may be used for certain post-transaction awards, whether under the pre-existing plan or another plan, without obtaining the approval of the acquiring company’s shareholders (the “M&A Exemption”). The M&A Exemption applies only if:

- the target has shares available for grant under plans that were previously approved by its shareholders (“Acquired Approved Plans”);
- the number of shares available for grant is appropriately adjusted to reflect the transaction;
• the shares are not made available for grant beyond the period during which they would have been available under the Acquired Approved Plan; and

• post-transaction awards are not granted to individuals who were employed immediately prior to the transaction by the acquiring company at the time the transaction was consummated.

It is important to note that, since a plan must be approved by shareholders in order to be an Acquired Approved Plan, the M&A Exemption does not apply to post-transaction awards of shares available under plans that were exempt from the shareholder approval requirements when adopted. In addition, the NYSE takes the position that listed companies may not avail themselves of the M&A Exemption for plans “adopted in contemplation of the merger or acquisition.”

Listed companies also should be aware that the M&A Exemption likely will have the effect of increasing administrative costs and creating additional complexities following a corporate transaction. In practice, following a corporate transaction, employees may be shifted from the acquiring entity to the target or vice versa, or employees from each entity may be assigned to new or revamped business divisions or subsidiaries.

In order to take advantage of the M&A Exemption, therefore, a listed company would need to track employees throughout each evolution in employment status in order to determine whether a particular individual is eligible to receive an award of shares available under an Acquired Approved Plan without obtaining further shareholder approval. Such an analysis will create arbitrary distinctions as to eligibility among employees who, post-transaction, are at identical compensation and responsibility levels and who perform substantially similar functions in different segments of the acquiring Company’s business. Many of these distinctions will be based on a transaction’s legal structure, which typically is driven by unrelated tax and corporate law concerns.

Finally, listed companies should be aware that the use of share reserves under an Acquired Approved Plan in connection with a transaction will be counted by the NYSE in determining whether a transaction must be approved by the shareholders of the acquiror as an issuance of more than 20% of its outstanding common stock.

Employment Inducement Awards. The NYSE Rules exempt equity awards that are a material inducement to a person’s first becoming an employee of the listed company or its subsidiaries, or awards made to rehires after a bona fide termination of employment. Unlike the proposed NASDAQ shareholder approval rules, the NYSE Rules do not specifically provide that the inducement awards exception applies to awards made to new directors. Inducement awards include grants to new employees in connection with a merger or acquisition. Promptly following any inducement award, a listed company must issue a press release disclosing the material terms of the award, including the identity of the recipient of the award and the number of shares awarded.

Tax Qualified and Parallel Excess Plans. Shareholder approval will also not be required for:

• tax qualified plans under Section 401(a) of the Internal Revenue Code (the “Code”), such as ESOPs and 401(k) plans;

• “parallel excess plans” (as detailed further below); and

• employee stock purchase plans intended to meet the requirements of Section 423 of the Code.

The NYSE commented that these exemptions are appropriate because such plans already are regulated under the Code and Treasury regulations, and noted in particular that Section 423 plans already require shareholder approval under the Code.

The NYSE Rules define a “parallel excess plan” as a pension plan that is designed to work in parallel with a tax qualified plan to provide benefits that exceed the applicable Code limits on contributions, eligible compensation and plan benefits. To be a parallel excess plan, the plan must:

• cover all or substantially all employees of an employer who are participants in the related qualified plan whose annual compensation exceeds the amount specified in Code Section 401(a)(17) and/or Code Section 415;

• have terms that are substantially the same as the terms of the qualified plan that it parallels except for the elimination of the applicable Code limits; and

• provide that no participant receives equity contributions under the plan in excess of 25% of the participant’s cash compensation.

In practice, many nonqualified plans routinely differ in various respects from the related qualified plan. For example:
• Assets of a qualified plan are required to be held in a trust qualified under Code Section 501(a), whereas nonqualified plans must be unfunded for tax purposes. For many nonqualified plans, no assets are set aside in trust for the benefit of plan participants and beneficiaries.

• By virtue of Code Section 402, participants in a qualified plan do not recognize income with respect to amounts held for their benefit until such amounts actually are distributed. The same treatment does not apply to nonqualified plans. As a result, nonqualified plans typically restrict the timing and manner of distributions in ways that do not apply to qualified plan benefits.

• It is not uncommon for a qualified plan to exclude bonus and other non-recurring components of compensation (such as income recognized upon exercise of stock options) from the definition of “covered compensation” under the plan. These limitations typically are intended to help ensure that the plan does not violate the nondiscrimination standards of the Code that apply to tax qualified plans. By contrast, a nonqualified plan may make up for benefits that could not otherwise have been contributed to a qualified plan because of these limits in order to ensure that participants’ retirement benefits take account of their total compensation.

Under a literal reading of the NYSE Rules, nonqualified plans that differ from the related qualified plan in any of the foregoing respects will not be considered “parallel excess plans.” Finally, the requirement that no participant may receive employer equity contributions to the plan in excess of 25% of his or her compensation may limit the applicability of this exception.

Other Related Rule Changes

**NYSE Prohibition on Proxy Voting Absent Specific Instructions.** The NYSE Rules also preclude member organizations from giving a proxy to vote on equity-compensation plans unless the beneficial owner of the shares has given voting instructions. While the NYSE plans to establish a working group to study the mechanisms required to implement this change, implementation will not be delayed pending the findings of the working group, and this rule will be effective for any meeting of the shareholders that occurs on or after 90 days from the SEC’s approval of the rule change.

This change may have significant impact on a listed company’s ability to get shareholder approval of equity-compensation plans, especially where a significant portion of the company’s shares are held in “street name” by member organizations on behalf of their clients.

**Non-U.S. Issuers**

The shareholder approval requirements of the NYSE Rules do 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. That section requires non-U.S. issuers to certify that they are in compliance with their home country practices regarding corporate governance, and to disclose how their home country practices differ.

The NYSE Rules also provide that equity-compensation plans that would be exempt from the shareholder approval requirements as tax qualified and related parallel plans or Section 423 plans, “but for features necessary to comply with applicable foreign tax law,” also are exempt from the shareholder approval requirement.

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**Implications**

Listed companies should review their equity compensation plans to ensure that they are in compliance with the final NYSE Rules, particularly in light of the complex transition provisions. We anticipate that the final Nasdaq rules regarding the shareholder approval requirements for equity compensation plans will not be far behind.
ENDNOTES

1 The NYSE commented that 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 the date of grant” will not be considered material.

2 The NYSE’s references to option repricings are crafted to cover all repricing structures, including option exchange offers, whereby holders of out-of-the-money options are offered the opportunity to surrender their options for cancellation in exchange for the issuer’s undertaking to issue new options on a date that is at least six months and one day after the date on which the original options are surrendered for cancellation.