Executive Overview

The Facts

On June 30, 2003, the SEC approved separate proposed rule changes from the New York Stock Exchange (the “NYSE”) and the Nasdaq Stock Market, Inc. (“Nasdaq”) that, subject to certain limited exemptions, require shareholder approval of the adoption or material revision of all equity compensation plans, including stock option plans. Both rules became effective on June 30, 2003, but only apply to equity compensation plans that are adopted or materially revised after that date. This memorandum summarizes the NYSE and Nasdaq rules, as well as broker voting rules that apply to both NYSE and Nasdaq listed companies.

Implications For Your Organization

The new rules govern shareholder approval requirements for equity compensation plans provided by companies that are subject to the listing standards of the NYSE or Nasdaq. Accordingly, listed companies that adopt or materially revise any equity compensation plan, as defined under the NYSE and Nasdaq rules, after June 30, 2003 will be required to solicit shareholder approval for such actions unless an exemption applies. Therefore, issuers subject to the rules should take into account the timing and expense involved in obtaining shareholder approval when considering the adoption or material revision of equity compensation plans and awards. In addition, issuers subject to the rules should review any existing equity compensation plan that provides for automatic formula grants or matching grants or that contains evergreen provisions to ensure that future grants under the plan will not be considered material revisions under the new NYSE or Nasdaq rules.

Overview of the NYSE Rule

The new NYSE rule requires shareholder approval of all equity compensation plans that are adopted or materially revised after June 30, 2003, subject to certain exemptions. There are five significant facets of the NYSE rule: (1) definition of “equity compensation plan”; (2) material revisions; (3) exempted arrangements; (4) repricings; and (5) transition and material revision rules for discretionary plans and formula plans.

Definition of “Equity Compensation Plan”

Any arrangement that falls within the NYSE definition of “equity compensation plan” is subject to the rule and, therefore, requires shareholder approval if adopted or materially revised, unless it falls within one of the limited exemptions. Under the NYSE rule, “equity compensation plan” is defined as “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 . . . [including] a compensatory grant of options or other equity securities that is not made under a plan.” For this purpose, an agreement with one individual could constitute a plan. The NYSE’s definition, however, also contains various exceptions. Any plans or arrangements that are excepted from the definition are not subject to the shareholder approval requirement. According to the NYSE rule, the following arrangements do not fall within the definition of equity compensation plan:

- plans that are made available to shareholders generally (e.g., typical dividend reinvestment plans); and
- plans that merely allow employees, directors or other service providers to purchase shares on the open market or from the listed company for current fair market value, regardless of whether the shares are delivered immediately or on a deferred basis or whether the payments for the shares are made directly or by giving up compensation that is otherwise due.
In addition, note that plans that provide for the payment of cash rather than the delivery of shares, even when the amount of cash is based on the price of the issuer’s shares (e.g., phantom stock plans), do not require shareholder approval. Finally, shareholder approval is required for a covered plan regardless of whether the plan uses newly issued shares or treasury shares.

**Exempted Arrangements**

In addition to the definitional exceptions discussed above, the NYSE has exempted the following types of arrangements from the shareholder approval requirement:

- employment inducement awards (i.e., grants of options or other equity-based compensation designed to induce a person to become an employee of the issuer or any of its subsidiaries, including those undertaken following a bona fide period of interruption of employment or in the context of a merger or acquisition), provided that the issuer must promptly disclose the material terms of any such awards in a press release;

- the conversion, replacement or adjustment of outstanding options or other equity compensation awards in connection with a merger or acquisition;

- certain post-merger or acquisition grants of options and other awards under plans acquired in the transaction that were previously approved by the target’s shareholders;

- plans intended to meet the requirements of Section 401(a) (e.g., ESOPs or 401(k) plans) or Section 423 (e.g., qualified employee stock purchase plans) of the Internal Revenue Code; and

- certain “parallel excess plans” that are narrowly defined by the NYSE rule as a “pension plan” within the meaning of the Employee Retirement Income Security Act that is designed to work in tandem with a plan intended to be qualified under Sections 401(a), 401(a)(17) and/or 415 of the Internal Revenue Code.

Although grants, plans or amendments that fall within an exemption do not require shareholder approval, the NYSE rule requires them to be approved by the company’s independent compensation committee or a majority of the company’s independent directors. Further, the company is also required to notify the NYSE in writing if it relies upon any exemption to execute any equity compensation grant, plan or amendment.

**Material Revisions**

The NYSE rule requires shareholder approval for any material revisions to an equity compensation plan. Under the rule, material revisions include, but are not limited to, the following:

- a material increase in the number of shares available under the plan (other than increases solely to reflect a reorganization, stock split, merger, spin-off or similar transaction);

- an expansion of the types of awards available under the plan;

- a material expansion of the class of employees, directors or other service providers eligible to participate in the plan;

- a material extension of the term of the plan;

- a material change to the method of determining the strike price of options under the plan; and

- the deletion or limitation of any provision prohibiting repricing of options.

Although the NYSE rule states that the curtailment of a plan will not be deemed a material revision, beyond providing the non-exhaustive list of above examples, the NYSE has left it to listed companies to determine whether a particular action constitutes a material revision.

**Repricings**

As noted above, the deletion or limitation of any provision prohibiting repricing of options is considered a material revision that requires shareholder approval. Under the NYSE rule, a “repricing” means any of the following actions or those having the same effect:

- lowering the strike price of an option after it is granted;

- any other action that is treated as a repricing under GAAP; or

- canceling an out-of-the-money option 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 corporate transaction.
Importantly, the NYSE rule provides that equity compensation plans that do not contain provisions that specifically permit repricing of options will be deemed to prohibit repricing. Thus, any repricing that occurs under such a plan will be viewed as a material revision of the plan, even if the plan itself is not actually revised, and will require shareholder approval. Nevertheless, shareholder approval will not be required for any repricing through an exchange offer that commenced before June 30, 2003.

**Transition and Material Revision Rules for Discretionary Plans and Formula Plans**

As defined in the NYSE rule, a formula plan is one that contains a formula for automatic increases in the shares available (sometimes called an “evergreen formula”) or for automatic grants pursuant to a formula. A discretionary plan, on the other hand, is one that does not contain a limit on the number of shares available and is not a formula plan. Under the NYSE rule, there are certain transition rules and material revision rules that apply only to discretionary and formula plans.

As stated previously, an equity compensation plan that was adopted before June 30, 2003 is not subject to the NYSE rule unless and until it is materially revised. In the case of discretionary plans, however, irrespective of whether they have been approved by shareholders, additional grants may be made after June 30, 2003 under such plans without further shareholder approval only for a limited transition period, as discussed below, and then only in a manner consistent with past practice. If a plan can be separated into a discretionary portion and a non-discretionary portion, the non-discretionary portion may continue to be used separately, subject to any applicable transition rules.

As applied to formula plans that have not previously been approved by shareholders or do not have a term of ten years or less, additional grants may be made after June 30, 2003 without further shareholder approval only for a limited transition period, as discussed below, or until the shares that were available immediately before June 30, 2003 have been used. A formula plan that has been approved by shareholders but does not have a term of ten years or less may continue to be used beyond the limited transition period if the plan is amended to provide for a term of ten years or less from the later of the date of the plan’s original adoption or its most recent shareholder approval. Under the NYSE rule, such an amendment would not be considered a material revision that requires shareholder approval.

The limited transition period applicable to both discretionary and formula plans ends upon the earliest of: (i) the company’s next annual meeting at which directors are elected that occurs after December 27, 2003; (ii) the first anniversary of the NYSE rule’s effective date, June 30, 2004; or (iii) the expiration of the plan.

In terms of material revisions, the NYSE rule states that each increase in the number of shares available under a formula plan, and each grant pursuant to an automatic formula, will be considered a material revision that requires shareholder approval, unless the plan has a term of not more than ten years. The NYSE rule also provides that each grant under a discretionary plan will be regarded as a material revision and will require shareholder approval prior to its implementation regardless of whether the plan has a term of not more than ten years.

**Overview of the Nasdaq Rule**

Unless an exemption applies, the new Nasdaq rule requires shareholder approval of stock option or purchase plans or other equity compensation arrangements (including individual agreements) pursuant to which options or stock may be acquired by officers, directors, employees or consultants that are established or materially amended after June 30, 2003.

**Exempted Arrangements**

The Nasdaq rule does not apply to, and shareholder approval is not required for, the following actions, issuances or plans:

- warrants or rights issued generally to all shareholders or stock purchase plans available on equal terms to all shareholders (e.g., typical dividend reinvestment plans);
- tax-qualified, non-discriminatory employee benefit plans (e.g., plans that meet the requirements of Section 401(a) or 423 of the Internal Revenue Code such as most ESOPs, 401(k) plans and qualified employee stock purchase plans) or parallel nonqualified plans, provided such plans are approved by the issuer’s compensation committee or a majority of the issuer’s independent directors;
- plans that merely provide a convenient way to purchase shares on the open market or from the issuer at fair market value;
- the conversion, replacement or adjustment of outstanding options or other equity compensation awards in connection with a merger or acquisition;
- certain post-merger or acquisition grants of options and other awards under plans acquired in the transaction that were previously approved by the target’s shareholders; and
• employment inducement awards (i.e., grants of options or other equity-based compensation designed to induce a person to become an employee of the issuer, including those undertaken following a bona fide period of non-employment or in the context of a merger or acquisition), provided such issuances are approved by either the issuer’s compensation committee comprised of a majority of independent directors or a majority of the issuer’s independent directors.

Note that, with the new rule, Nasdaq has eliminated the previously existing exception from the shareholder approval requirement for broadly based equity compensation plans. The new rule also eliminates the de minimis exception for the grant of the lesser of 1% of the issuer’s common stock or 25,000 shares.

Although the new rule currently does not contain a requirement that an issuer notify Nasdaq in writing when it relies on an exemption from the shareholder approval requirements, Nasdaq has committed to the SEC that it will consider such a requirement.

Material Amendments
The Nasdaq rule requires shareholder approval for any material amendment of a stock option plan, stock purchase plan or other equity compensation arrangement. Under Nasdaq’s interpretations, material amendments include, but are not limited to, the following:

• any material increase in the number of shares to be issued under the plan (other than to reflect a reorganization, stock split, merger, spin-off or similar transaction);

• any material increase in benefits to participants, including any material change to: (i) permit a repricing (or decrease in exercise price) of outstanding options, (ii) reduce the price at which shares or options to purchase shares may be offered, or (iii) extend the duration of a plan;

• any material expansion of the class of eligible plan participants; and

• any expansion in the types of options or awards provided under the plan.

Beyond the non-exhaustive list of above examples, Nasdaq has left it to listed companies to determine whether a particular action constitutes a material amendment.

Although Nasdaq’s interpretive material indicates that general authority to amend a plan does not obviate the need to obtain shareholder approval, if a plan itself permits a specific action without shareholder approval, then such approval is not required. Any plan provision permitting certain action without further shareholder approval must be clear and specific enough to provide meaningful shareholder approval of the provision.

Repricings
As noted above, an amendment to a plan or arrangement to permit repricing or to decrease the exercise price of outstanding options is considered a material amendment that requires shareholder approval. Accordingly, Nasdaq recommends that plans intended to permit repricing use explicit terminology to make it clear that is the case.

Special Rules for Discretionary Plans and Formula Plans
The Nasdaq interpretive material states that if a plan contains a formula for automatic increases in the shares available (sometimes called an “evergreen formula”), or for automatic grants pursuant to a dollar-based formula, the plan may not have a term in excess of ten years unless shareholder approval is obtained every ten years. Further, shareholder approval is required for each grant under a discretionary plan (i.e., a plan that does not limit the number of shares available for grant).

Broker Voting
The NYSE rule precludes brokers who are NYSE members from giving proxies to vote on equity compensation plans that are presented to shareholders for approval unless they receive instructions from the beneficial owners of the shares being voted. This provision amends NYSE Rule 452 and will be effective for shareholder meetings that occur on or after September 28, 2003. The Nasdaq rule, on the other hand, does not specifically address this issue, but NASD rules prohibit discretionary voting by brokers without explicit instructions from the beneficial owner. These broker-voting rules apply for all listed companies regardless of whether they are listed on the NYSE or Nasdaq.

Obtaining the SEC’s Release
You can locate the SEC’s release, which contains greater detail about the new NYSE and Nasdaq rules, on the SEC’s Web site at:
For more information on the foregoing or other securities matters, please contact one of the authors of this client memorandum (John P. Boelter at 312-569-1107 or Kimberly K. Rubel at 312-569-1133), any member of our Securities Practice Group listed below, or your regular Gardner Carton & Douglas contact.

### SECURITIES PRACTICE GROUP

<table>
<thead>
<tr>
<th>Name</th>
<th>Email</th>
<th>Phone</th>
</tr>
</thead>
<tbody>
<tr>
<td>John P. Boelter</td>
<td><a href="mailto:jboelter@gcd.com">jboelter@gcd.com</a></td>
<td>(312) 569-1107</td>
</tr>
<tr>
<td>Nancy Borders</td>
<td><a href="mailto:nborders@gcd.com">nborders@gcd.com</a></td>
<td>(312) 569-1108</td>
</tr>
<tr>
<td>Troy M. Calkins</td>
<td><a href="mailto:tcalkins@gcd.com">tcalkins@gcd.com</a></td>
<td>(202) 230-5139</td>
</tr>
<tr>
<td>Dewey B. Crawford</td>
<td>dcr <a href="mailto:crawford@gcd.com">crawford@gcd.com</a></td>
<td>(312) 569-1111</td>
</tr>
<tr>
<td>Joseph H. Greenberg</td>
<td><a href="mailto:jgreenberg@gcd.com">jgreenberg@gcd.com</a></td>
<td>(312) 569-1119</td>
</tr>
<tr>
<td>Marielle V. Lifshitz</td>
<td><a href="mailto:mlifshitz@gcd.com">mlifshitz@gcd.com</a></td>
<td>(312) 569-1123</td>
</tr>
<tr>
<td>Charles R. Manzoni</td>
<td><a href="mailto:cmanzoni@gcd.com">cmanzoni@gcd.com</a></td>
<td>(312) 569-1125</td>
</tr>
<tr>
<td>George C. McKann</td>
<td><a href="mailto:gmckann@gcd.com">gmckann@gcd.com</a></td>
<td>(312) 569-1127</td>
</tr>
<tr>
<td>Helen J. McSweeney</td>
<td><a href="mailto:hmcsweeney@gcd.com">hmcsweeney@gcd.com</a></td>
<td>(312) 569-1128</td>
</tr>
<tr>
<td>Kimberly K. Rubel</td>
<td>k <a href="mailto:rubel@gcd.com">rubel@gcd.com</a></td>
<td>(312) 569-1133</td>
</tr>
<tr>
<td>David A. Rubenstein</td>
<td>dr <a href="mailto:rubenstein@gcd.com">rubenstein@gcd.com</a></td>
<td>(312) 569-1134</td>
</tr>
<tr>
<td>Nancy L. Stern</td>
<td><a href="mailto:nstern@gcd.com">nstern@gcd.com</a></td>
<td>(312) 569-1140</td>
</tr>
<tr>
<td>Stephen Tsoris</td>
<td><a href="mailto:stsorisis@gcd.com">stsorisis@gcd.com</a></td>
<td>(312) 569-1142</td>
</tr>
<tr>
<td>Robert J. Wilczek</td>
<td>r <a href="mailto:wilczek@gcd.com">wilczek@gcd.com</a></td>
<td>(312) 569-1143</td>
</tr>
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