

Corporate Finance Alert

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New NASDAQ and NYSE Rules Requiring Shareholder Approval of Equity Compensation Plans Approved by the SEC

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On June 30, 2003, the Securities and Exchange Commission approved rule changes adopted by the Nasdaq Stock Market and the New York Stock Exchange that require shareholders to approve new equity compensation plans or material modifications to existing plans. Subject to limited exceptions, the rule changes effectively prohibit Nasdaq and NYSE listed companies from issuing any equity securities to employees, officers, directors and service providers without first obtaining shareholder approval. However, other than in limited circumstances, existing plans that were not previously approved by shareholders do not need shareholder approval unless material revisions are undertaken. While the American Stock Exchange has not yet adopted comparable rules, Amex listed companies should anticipate that such rule changes will occur.

Equity Compensation Plans

Under the new rules, any new equity compensation plan that is adopted by a Nasdaq or NYSE listed company, other than exempted or excluded plans, must be approved by shareholders prior to the issuance of any equity security under it. The NYSE rule (Section 303A(8) of the NYSE's Listed Company Manual) defines an "equity compensation plan" 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. Even a compensatory grant of options or other equity securities that is not made under a plan is, nonetheless, an 'equity compensation plan' for these purposes."

Unlike the NYSE rule, the Nasdaq rules do not expressly define the term "equity compensation plan." Rather, the amended Nasdaq rules provide that, other than in limited circumstances, shareholder approval is required "when a stock option or purchase plan is to be established or materially amended or other equity compensation arrangement made or materially amended pursuant to which options or stock may be acquired by officers, directors, employees or consultants."

Both the Nasdaq and the NYSE rules contain limited exceptions and exemptions from the requirement that shareholder approval be obtained. While the language varies slightly

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between the NYSE and Nasdaq rules, generally the following types of plans/issuances will not require shareholder approval:

- plans that do not provide for the award of equity securities, but rather for cash awards;
- plans that provide generally for the issuance of equity securities to all security holders of the company (e.g., typical dividend reinvestment plans);
- certain tax qualified plans (e.g., ESOPs) and related supplemental plans;
- plans that provide for the purchase of shares for fair market value;
- issuances to a person not previously employed by the company or rehired by the company after a bona fide interruption of employment, as an inducement to being hired; and
- certain issuances under plans adopted by acquired companies.

In certain circumstances, Nasdaq and the NYSE indicate that such exceptions and exemptions will apply only if affirmative action to authorize grants is taken by an independent Board committee.

One particularly fundamental change that results from the new rules is the need for shareholder approval for individual grants of equity securities (including securities that are convertible into equity securities) to employees, directors or service providers that are not from any “plans.” Thus, for example, the grant of options or warrants

to a consultant for services rendered falls within the new shareholder approval requirement unless the grant is from a shareholder approved plan.

Material Revisions

In addition to requiring shareholder approval for the adoption of new equity compensation arrangements, the new Nasdaq and NYSE rules also require that shareholders approve material revisions to existing equity compensation plans. Examples of material revisions include:

- material increases in the number of shares available under the plan (other than for increases resulting from stock splits, mergers, spinoffs or similar transactions);
- expansions of the types of awards available under the plan;
- any material expansion of the class of person eligible to participate in the plan;
- any material extension of the term of the plan; and
- a material change to permit repricings under the plan or to change existing limitations on repricings.

In each of the Nasdaq and NYSE rule changes, the list of material modifications is non-exclusive. Thus, before any changes to existing plans are made, Nasdaq and NYSE listed companies should consider whether the revisions are material, and might also consider discussing the changes with Nasdaq or NYSE, as the case may be.

With respect to repricings of awards, both Nasdaq and NYSE indicate that if an issuer wants to permit repricings under its plan, its plan must include specific provisions to permit repricings. Plans that do not expressly address repricings are interpreted not to permit them. A repricing of awards from any plans that do not specifically permit them will be considered a material revision.

Existing Plans

Generally, existing plans of Nasdaq and NYSE listed companies do not now need to be approved by shareholders (absent material revisions), even if such plans were not previously approved by shareholders. However, if any pre-existing plans contain a formula for automatic increases in the number of shares available for issuance under a plan or for automatic grants pursuant to a formula, or do not contain a fixed number of shares that are available for grant, shareholder approval may be required. Both the Nasdaq and the NYSE rules require that existing formula plans either be approved by shareholders or have terms of not more than ten years. Formula plans that were approved by shareholders and that have terms longer than ten years need to be modified to reduce the term. The NYSE has indicated that such a modification would not be considered to be “material.” Absent either such approval or term limit, the Nasdaq rules immediately prohibit the grant of any awards under such plans and the NYSE rules will prohibit such awards after the expiration of a transition period. Existing plans that do not have a fixed number of shares available for grant will require shareholder approval for any future grants (the transition period under the NYSE rules would apply to these plans as well).

Suggested Actions

All Nasdaq and NYSE listed companies should consider taking the following steps:

- review all existing equity compensation plans;
- determine whether shareholder approval was previously obtained for existing plans;
- determine whether material revisions are required or desired in light of the new rules;
- cease making individual grants of equity awards until a determination is made that such grants comply with the new rules; and
- analyze each proposed modification of an equity compensation plan to determine whether shareholder approval is required.

Amex listed companies should begin to consider taking similar action as well.

As we have done with the other corporate governance reform developments, we will keep you posted on the status of these rules and on any substantive modifications that the SEC or the exchanges make.

For more information about the new Nasdaq or NYSE rules, please contact Peter H. Ehrenberg, Member of the Firm and Chairman of Lowenstein Sandler’s Corporate Department and its M&A and Corporate Finance Practice Group, Andrew E. Graw, Member of the Firm, or Jeffrey M. Shapiro, Counsel and a member of the M&A and Corporate Finance Practice Group, at (973) 597-2500.