FENWICK & WEST LLP

CORPORATE & SECURITIES LAW UPDATE

Shareholder Approval Required for Equity Compensation Plans

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On June 30, 2003, the SEC approved new rules requiring any company listed on NASDAQ or the New York Stock Exchange to obtain shareholder approval before adopting any new equity compensation plan or materially amending an equity compensation plan. The new rules are effective immediately. In a related development, the SEC approved a NYSE rule change, effective September 28, 2003, that will prevent NYSE member brokers that hold shares in street name from voting the shares on equity plan proposals without specific direction from the beneficial shareholder.

The complete text of the final rules can be found at: http://www.sec.gov/rules/sro/34-48108.htm.

What is the rationale for the new rules?
Equity incentives are widely recognized as important components of compensation programs that help align the interests of shareholders and management. Equity compensation plans help in the recruiting and retention of qualified employees, executives and directors. However, these plans create potential dilution for shareholders, and some companies have been criticized for making excessive grants of stock options to executives. The new rules are designed to require a greater shareholder voice and to function as a check on potential dilution.

What plans are subject to the new rules?
The rules cover equity compensation plans and arrangements generally. The NASDAQ rules apply to any plan or other arrangement that provides for the delivery of equity securities as compensation for services to any employee, officer, director or consultant (to any employee, director or other service provider, in the case of NYSE companies). Grants or awards made outside of formal plans are themselves considered "equity compensation plans" for purposes of the rules. Limited exceptions apply, as discussed below.

What happened to the existing NASDAQ exceptions to the rule requiring shareholder approval of stock plans?
NASDAQ rules have long required shareholder approval of stock plans, with some significant exceptions. Companies frequently relied upon exceptions for "broad-based" plans (participation not restricted to executives) and for de minimus grants or plans (lesser of 1% or 25,000 shares). Those exceptions have now been eliminated as part of the new rules.

Are our existing equity plans "grandfathered"?
Yes. The rules effectively "grandfather" plans in existence on June 30, 2003. No new shareholder approval is required for typical plans that are currently in place.

When is shareholder approval required?

Effective immediately, shareholder approval is required for any new equity compensation plan or for any material amendment to an equity compensation plan.

What constitutes a "material' amendment or revision to a plan?

NASDAQ's non-exclusive list of changes that would be considered material includes:

- A material increase in the number of shares available under the plan;
- Any expansion in the types of awards available under the plan;
- A material expansion of the class of participants eligible to participate in the plan; and
- A material increase in benefits to the participants under the plan, including changes to:
  - Permit repricing of outstanding options;
  - Reduce the price at which options may be granted; or
  - Extend the term of the plan.

NYSE's list includes additional examples of material revisions:

- Material changes to the method of determining the exercise price of options; and
- Deletion or limitation on any provision prohibiting option repricing.

What is an example of a change that would not be considered material?

A change in the method of determining the fair market value of the stock for purposes of setting an option exercise price, from the closing price on date of grant to the average of the high and low price on the date of grant, was cited by the NYSE as an example of a change that would not be material.

What about amendments that limit plan activity?

An amendment that curtails the scope of a plan, rather than expanding it, will not be considered a material revision requiring shareholder approval.

What plans are exempt from the shareholder approval requirement?

Some types of plans do not raise the concerns that seem to have inspired these new rules:

- For both NASDAQ-listed and NYSE-listed companies, employee stock purchase plans and employee stock ownership plans and parallel excess plans are not subject to the rules. However, the plan must be approved by the company's compensation committee (consisting of a majority of independent directors) or by a majority of the independent directors.

- Similarly, plans that merely provide a convenient way to purchase shares on the open market, or from the company at fair market value, are also exempt.

- In addition:

  - The NASDAQ rules provide that warrants or rights issued generally to all security holders of the company or stock purchase plans available on equal terms to all security holders of a company (such as dividend reinvestment plans) are exempt from the shareholder approval requirement; and

  - The NYSE rules provide that plans that do not provide for the delivery of equity securities (*e.g*, plans that pay in cash) are exempt.

If you believe your plan may be exempt from the shareholder approval requirement, you should consult with counsel to confirm.

Our option plan has an "evergreen" provision and provides for "formula" grants to directors. What is the effect of the rules on these plan provisions?
Under both the NASDAQ and NYSE rules, if the plan has a term of 10 years or less (as most do), no shareholder approval is required. Otherwise, the addition of shares provided under the "evergreen" provision, and each "formula" option grant, would be treated as a material amendment requiring shareholder approval.

We have a stock option plan that has a specific limit on the number of shares available for grant, but no evergreen or formula grant features. Do grants under this plan require shareholder approval?
No. So long as your non-formula plan has a limit on the number of shares available for grant, no new shareholder approval is required. However, if there is no cap, each grant under the plan would require shareholder approval.

I've heard that "inducement awards" are exempt from shareholder approval. What are they?
An option grant made to a person who has not been an employee or director of the company before (or who returns after some period of bona fide non-employment) is considered an "inducement award" and is exempt from shareholder approval requirements. However, either the Compensation Committee (comprising a majority of independent directors) or a majority of the Board's independent directors must approve the award. Inducement awards made in the

context of a merger or acquisition are also exempt from the shareholder approval requirement.

Can we still issue options in the context of a merger or an acquisition without getting shareholder approval?
Yes. Options or equity awards issued to convert, replace or adjust outstanding options or other equity-based awards to reflect an acquisition transaction do not require shareholder approval.

What happens to the shares reserved under a target company's equity plans? Can they be used after the acquisition to grant options without shareholder approval?
Yes, within limits. If the target's equity plan was approved by its shareholders (and was not adopted in contemplation of the acquisition) the acquiring company, without shareholder approval, may use the shares under the target's plan for option grants and equity awards after the acquisition, but only to employees of the target and within the limits of the plan.

Do shares in a target company's pre-existing plan count toward the 20% threshold after which shareholder approval of the acquisition is required?
Yes. Any shares available for issuance under a plan acquired in connection with a merger or acquisition would be counted in determining whether the transaction involves the issuance of 20% or more of a company's outstanding stock, which triggers the shareholder approval requirement for the transaction under both NASDAQ and NYSE rules.

Does the repricing of an option or the commencement of an option exchange program to reprice a series of options require shareholder approval?
It depends. The rules governing NYSE-listed companies are explicitly restrictive, while the rules governing NASDAQ-listed companies have more flexibility.

For NYSE companies, option repricings are only permitted if they are expressly permitted under the stock option plan. In the absence of explicit permission in the plan, any option repricing would be considered a material revision of the plan requiring shareholder approval. Shareholder approval is not required with respect to a repricing pursuant to an exchange offer begun prior to June 30, 2003, assuming that no shareholder approval was required under the rules existing prior to June 30. The NYSE rules expressly include in the concept of repricing:

- Lowering the exercise price of an option after it is granted;
- Any action that would be treated as a repricing under GAAP; and
- Canceling an underwater option in exchange for a new option or other security (except in connection with a merger or acquisition).

For NASDAQ companies, shareholder approval of a stock option repricing or an option exchange program is required only if a material amendment of the plan is required to effect the repricing. Unlike the NYSE rules, NASDAQ rules do not mandate express language in the option plan regarding repricings. NASDAQ does recommend that plans meant to permit repricing use explicit terminology to make that clear to shareholders. If a NASDAQ-listed company's option plan permits amendment of the terms, including price, of existing stock option agreements without shareholder approval, then no further shareholder approval is required. Similarly, if the plan permits options to be terminated and new options to be granted in exchange therefor after a delay of six months or otherwise, shareholder approval should not be required. However, if the plan does not already permit the action necessary to effect a repricing to be taken, then shareholder approval must be obtained.

Because option repricings are sensitive, we recommend that you consult with your advisors in planning any such activity.

Are there any new requirements to notify NASDAQ or NYSE about equity plan matters?
Yes. NASDAQ is considering requiring disclosure whenever a company relies on an exception to the shareholder approval requirement. NASDAQ also proposes to require companies to notify it no later than 15 days prior to establishing or amending (without shareholder approval) a stock option plan, a stock purchase plan or other equity compensation arrangement pursuant to which stock may be acquired by officers, directors, employees or consultants. NYSE-listed companies must notify the NYSE in writing when relying on any exemption from shareholder approval requirements, such as inducement awards and acquisition-related grants.

How has the broker vote rule been changed?
Effective September 28, 2003 brokers who are NYSE members may not vote shares, or grant proxies to vote shares, with respect to any equity compensation plan matters unless the broker has received specific authorization to do so from the beneficial owner of the shares. This is a significant change to the "routine broker voting" rule that currently applies to brokers that hold a large percentage of public company shares on behalf of their customers.

Why is the change to the broker vote rule important?
This change will make it more difficult for companies to adopt new equity incentive plans and to modify those plans or increase the number of shares available under existing plans. It will tend to increase the costs of proxy solicitation when equity compensation plans are considered.

Are these new rules effective now?
The NYSE and NASDAQ listing criteria changes are already effective—as of June 30, 2003. The broker vote rule will be effective September 28, 2003. If, for example, you have an

annual meeting prior to September 28 at which a 2% increase in the stock option pool is proposed for shareholder approval, you will be in compliance with the listing requirement for seeking shareholder approval, and brokers will be able to vote shares without specific shareholder direction as a routine matter.

What if I have more questions?

If you have any questions about these new rules, please contact any member of your Fenwick & West team. You may also contact Scott Spector (sspector@fenwick.com), Horace Nash (hnash@fenwick.com) or Valarie McInroy (vmcinroy@fenwick.com), each of whom contributed to this update.

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