

of options or stock to new employees in connection with a merger or acquisition.

In addition, the proposed amendments to NASD Rule 4350(i) would clarify that plans involving a merger or acquisition would not require shareholder approval in two situations. First, Nasdaq will not require shareholder approval to convert, replace or adjust outstanding options or other equity compensation awards to reflect the transaction. Second, Nasdaq represents that shares available under certain plans acquired in corporate acquisitions and mergers may be used for certain post-transaction grants without further shareholder approval. Nasdaq clarifies that this exception applies to situations where the target/acquired company, which is no longer a listed company following the transaction, has shares available for grant under its pre-existing plans that were previously approved by its shareholders. Nasdaq represents that these shares may be used for post-transaction grants of options and other equity awards by the acquiring/listed company (after appropriate adjustment of the number of shares to reflect the transaction), either under the pre-existing plan or another plan, without further shareholder approval, so long as: (1) The time during which those shares are available for grants is not extended beyond the period when they would have been available under the pre-existing plan, absent the transaction, and (2) such options and other awards are only granted to individuals who were employed by the target/acquired company at the time the merger or acquisition was consummated. Nasdaq would view a plan adopted in contemplation of the merger or acquisition transaction as not pre-existing for purposes of this exception. Nasdaq believes that this exception is appropriate because it believes that it will not result in any increase in the aggregate potential dilution of the combined enterprise.

Nasdaq states that, under the proposed amendments to the NASD Rule 4350(i), inducement grants, tax qualified, non-discriminatory benefit plans, and parallel nonqualified plans are subject to approval by either the issuer's compensation committee, or a majority of the issuer's independent directors. Nasdaq also notes that a company would not be permitted to use repurchased shares to fund options without prior shareholder approval. Nasdaq represents, however, that plans that merely provide a convenient way to purchase shares on the open market or from the issuer at fair market value would not require shareholder approval.

The Nasdaq proposal further clarifies that material amendments to plans would require shareholder approval. The accompanying proposed "Interpretative Material" also provides a non-exclusive list of plan amendments that are considered material, and clarifies that while general authority to amend a plan would not obviate the need for shareholder approval, if a plan permits a specific action without further shareholder approval, then no such approval would be required.<sup>24</sup> Certain provisions in a plan, however, cannot be amended without shareholder approval. For example, plans that contains a formula for automatic increases in the shares available or for automatic grants pursuant to a dollar-based formula cannot have a term in excess of ten years unless shareholder approval is obtained every ten years. In addition, plans that impose no limit on the number of shares available for grant would require shareholder approval of each grant under the plan. A requirement that grants be made out of treasury shares or repurchased shares will not alleviate these additional shareholder approval requirements. The proposed "Interpretative Material" also provides that as a general matter, when preparing plans and presenting them for shareholder approval, issuers should strive to make plan terms easy to understand. In that regard, Nasdaq recommends that plans meant to permit repricing use explicit terminology to make this clear.

With respect to implementation of the proposed amendments to NASD Rule 4350(i), Nasdaq proposes that amended NASD Rule 4350(i) become effective upon SEC approval, and that existing plans be grandfathered.<sup>25</sup> Nasdaq represents that any material modification to plans in place or adopted after the effective date of NASD Rule 4350(i) would require shareholder approval.

Separately, Nasdaq represents that Nasdaq staff intends to consider further changes to provide greater transparency to investors, including a possible disclosure requirement with respect to situations where an issuer relies upon

<sup>24</sup> The Commission notes that if a plan permits a specific action without further shareholder approval, it must be clear and specific enough to provide meaningful shareholder approval of those provisions.

<sup>25</sup> The Commission notes that the Nasdaq proposal does not address broker-dealer discretionary voting because NASD rules currently prohibit discretionary voting by broker-dealers without explicit instructions from the beneficial owner. In addition, the Commission notes that the Nasdaq proposal does not eliminate the "treasury share exception" because Nasdaq does not have such an exception under current NASD rules.

an exception to the shareholder approval requirements of NASD Rule 4350(i)(1)(A).

Lastly, Nasdaq proposes to make conforming changes to NASD Rules 4310(c)(17)(A) and 4320(e)(15)(A). These proposed changes will require issuers to notify Nasdaq on the appropriate form no later than 15 calendar days prior to establishing or materially amending a stock option plan, purchase plan or other equity compensation arrangement pursuant to which stock may be acquired by officers, directors, employees, or consultants without shareholder approval.

## 2. Amended NASD Rule 4350(i) and IM-4350-5

As amended by Nasdaq Amendments No. 2 and 3, NASD Rule 4350(i)(1)(A) and proposed new "Interpretative Material," IM-4320-5, will read as follows:

### (i) Shareholder Approval

(1) Each issuer shall require shareholder approval prior to the issuance of designated securities under subparagraph (A), (B), (C), or (D) below:

(A) 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, except for:

(i) 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 the company (such as a dividend reinvestment plan); or

(ii) 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) or parallel nonqualified plans, provided such plans are approved by the issuer's compensation committee or a majority of the issuer's independent directors; or plans that merely provide a convenient way to purchase shares on the open market or from the issuer at fair market value; or

(iii) plans or arrangements relating to an acquisition or merger as permitted under IM-4350-5; or

(iv) issuances to a person not previously an employee or director of the company, or following a bonafide period of non-employment, as an inducement material to the individual's entering into employment with the company, provided such issuances are approved by either the issuer's compensation committee comprised of a majority of independent directors or a