

the new employees, and its interests are directly aligned with those of shareholders. The Exchange believes that any potential abuse of the inducement exception would be mitigated by the requirement that the company's independent compensation committee or a majority of the company's independent directors approve the inducement grant. In addition, a listed company relying on the inducement award exception, as set forth in Rule 31.79(a), must disclose in a press release the material terms of the award, including the recipient(s) of the award and the number of shares involved.

Proposed CBOE Rule 31.79(b), a new exception based on the Nasdaq/NYSE Proposals, does not require shareholder approval for tax qualified, nondiscriminatory benefit plans, as these plans are regulated under the Internal Revenue Code and Treasury Department regulations. However, the listed company's independent compensation committee or a majority of the listed company's independent directors must approve these plans. Along with tax qualified, non-discriminatory employee benefit plans, proposed CBOE Rule 31.79(b) also proposes an exception for parallel nonqualified plans. The proposed rule change would not impact any shareholder approval or other requirements under the Internal Revenue Code or other applicable laws or requirements for such plans. Additionally, an equity compensation plan that provides non-U.S. employees with substantially the same benefits as a comparable tax qualified, non-discriminatory employee benefit plan or parallel nonqualified plan that the issuer provides to its U.S. employees, but for features necessary to comply with applicable foreign tax law, is also exempt from the shareholder approval requirements.

Proposed Interpretation .01 to CBOE Rule 31.79 makes clear that a company would not be permitted to use repurchased shares to fund options plans without prior shareholder approval. However, 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.

With respect to plans or arrangements relating to an acquisition or merger, as set forth in proposed CBOE Rule 31.79(c), proposed Interpretation .01 to CBOE Rule 31.79 makes clear that these plans or arrangements would not require shareholder approval in two situations. First, shareholder approval will not be required to convert, replace

or adjust outstanding options or other equity compensation awards to reflect the transaction. Second, shares available under certain plans acquired in acquisitions and mergers may be used for certain post-transaction grants without further shareholder approval. This exception applies to situations where the party that is not a listed company following the transaction has shares available for grant under pre-existing plans that were previously approved by shareholders. These shares may be used for post-transaction grants of options and other equity awards by the 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 not granted to individuals who were employed by the granting company or its subsidiaries at the time the merger or acquisition was consummated. The Exchange would view a plan adopted in contemplation of the merger or acquisition transaction as not pre-existing for purposes of this exception. The Exchange believes that this exception is appropriate because it believes that it would not result in any increase in the aggregate potential dilution of the combined enterprise.

Finally, proposed CBOE Rule 31.79(d) sets forth a new exception for warrants or rights offered generally to all shareholders. The Exchange believes that this issuance does not raise the same concerns regarding self-dealing and dilution as other, more exclusive stock option plans or arrangements may create.

The Exchange's proposal also clarifies that only material amendments to plans (including existing plans) will require shareholder approval. Proposed Interpretation .01 to CBOE Rule 31.79 specifies a non-exclusive list of plan amendments that would be considered material. While broad, 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>6</sup> Certain provisions in a plan, however, cannot be amended without shareholder approval. For example, plans that contain a

<sup>6</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.

formula for automatic increases in the shares available (sometimes called an "evergreen formula") or that automatically grant shares 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 do not contain a formula and do not impose a 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. Proposed Interpretation .01 to CBOE Rule 31.79 also provides that issuers should strive to make plan terms easily understandable and that plans meant to permit repricing should use explicit terminology in this regard.

Proposed Interpretation .01 to CBOE Rule 31.80 reflects the concept set forth in proposed Interpretation .01 to CBOE Rule 31.79, that additional shares available for issuance under a stock option or purchase plan or other equity compensation arrangement acquired in connection with a merger or acquisition are counted in determining whether the transaction involved the issuance of 20% or more of the company's outstanding common stock. Furthermore, the Exchange proposes to amend CBOE Rule 31.96 and the Listing Agreement set forth on CBOE Form 1 to require issuers to notify the Exchange in writing prior to the use of any of the exceptions set forth in paragraphs (a) through (d) of CBOE Rule 31.79.

In addition, the Exchange proposes to amend CBOE Rule 31.85 to preclude the Exchange's member organizations from giving a proxy to vote on equity compensation plans unless the beneficial owner of the shares has given voting instructions.

## 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6 of the Act,<sup>7</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>8</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. As previously noted, the Exchange believes that the proposed rule change will strengthen shareholder approval

<sup>7</sup> 15 U.S.C. 78f(b).

<sup>8</sup> 15 U.S.C. 78f(b)(5).