

also proposes to amend Phlx Rule 862, *Proxies at Direction of Owner*, to preclude broker voting on equity compensation plans.

Below is the text of the proposed rule change.<sup>4</sup> Proposed new language is *italicized*; proposed deleted language is [bracketed].

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#### Rule 850, Shareholder Approval Policy

Rule 850. [A listed company shall require shareholder approval of the issuance of securities in connection with the following:

(a) Options plans or other special remunerations plans for directors, officers or key employees.] *Each issuer shall require shareholder approval prior to the issuance of designated securities under subparagraph (a), (b), or (c) 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 independent 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 the Commentary to this rule; 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 independent compensation committee or a majority of the issuer's independent directors. Promptly following an issuance of any employment inducement grant in reliance on this exception, a company must disclose in a press release the material terms of the grant, including the recipient(s) of the grant and the number of the shares involved.*

Issuers shall notify the Exchange 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.

(b) No change.

(c) No change.

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#### Commentary

Employee ownership of company stock can be an effective tool to align employee interests with those of other shareholders. Stock option plans or other equity compensation arrangements can also assist in the recruitment and retention of employees, which is especially critical to young, growing companies, or companies with insufficient cash resources to attract and retain highly qualified employees. However, these plans can potentially dilute shareholder interests. As such, Rule 850(a) ensures that shareholders have a voice in these situations, given this potential for dilution.

Rule 850(a) requires shareholder approval when a plan or other equity compensation arrangement is established or materially amended. For these purposes, a material amendment would include, but not be limited to, the following:

(1) Any material increase in the number of shares to be issued under the plan (other than to reflect a reorganization, stock split, merger, spinoff or similar transaction);

(2) 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;

(3) Any material expansion of the class of participants eligible to participate in the plan; and

(4) Any expansion in the types of options or awards provided under the plan.

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 generally be required. However, 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 (such as, annual grants based on a certain dollar value, or matching contributions based upon the amount of compensation the participant elects to defer), such plans cannot have a term in excess of ten years unless shareholder approval is obtained every ten years. However, 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.

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, it is recommended that plans meant to permit repricing use explicit terminology to make this clear.

Rule 850(a) provides an exception to the requirement for shareholder approval for warrants or rights offered generally to all shareholders. In addition, an exception is provided for tax qualified, non-discriminatory employee benefit plans as well as parallel nonqualified plans as these plans are regulated under the Internal Revenue Code and Treasury Department regulations. 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 that the issuer provides to its U.S. employees, but for features necessary to comply with applicable foreign tax law, are also exempt from shareholder approval under this section.

recently approved for the New York Stock Exchange, Inc. ("NYSE") and the NASD, through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"). See Securities Exchange Act Release No. 48108 (June 30, 2003), 68 FR 39995 (July 3, 2003) (order approving File Nos. SR-NYSE-2002-46 and SR-NASD-2002-140). See also Securities Exchange Act Release No. 48627 (October 14, 2003), 68 FR 60426 (October 22, 2003) (notice of filing and order granting accelerated approval to File No. SR-NASD-2003-130, incorporating amendments to the NASD's recently approved shareholder approval rules for equity compensation plans applicable to Nasdaq quoted securities). The Commission also published a correction to the notice of File No. SR-NASD-2003-130. See Securities Exchange Act Release No. 48627A (October 22, 2003), 68 FR 61532 (October 28, 2003). The Commission notes that these additional amendments by Nasdaq make the NYSE and Nasdaq proposals more consistent and uniform. See also *infra* note (regarding the Commission's recent approval of a similar proposal by the American Stock Exchange LLC ("Amex")).

<sup>4</sup> Upon the Exchange's request, the Commission made a technical correction to the proposed rule text. Telephone conversation between Carla Behnfeldt, Director, Legal Department New Product Development Group, Phlx, and Sapna C. Patel, Special Counsel, Division of Market Regulation, Commission, on October 31, 2003.