

Notwithstanding the foregoing, a member organization may not give a proxy to vote without instructions from beneficial owners when the matter to be voted upon authorizes the implementation of any equity compensation plan, or any material revision to the terms of any existing equity compensation plan (whether or not stockholder approval of such plan is required by Rule 850.)

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item III below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to revise Exchange Rule 850 to require shareholder approval for stock option plans or other equity compensation arrangements (subject to exceptions specified in the rule), to adopt a "Commentary" pertaining to shareholder approval for stock option plans or other equity compensation arrangements, and to revise Exchange Rule 862 to preclude broker voting in connection with shareholder approval of equity compensation plans.

Specifically, the Exchange proposes to adopt an exception for warrants or rights offered generally to all shareholders. The exception would exclude stock purchase plans available on equal terms to all security holders of the company (such as a dividend reinvestment plan) from the shareholder approval requirement. In addition, the proposal would not require shareholder approval for tax qualified, non-discriminatory benefit plans as these plans are regulated under the Internal Revenue Code and Treasury Department regulations. Along with tax qualified, non-discriminatory employee benefit plans, the Exchange's proposal also provides an exception for parallel nonqualified plans, which are plans that work parallel with plans intended to

qualify under the Internal Revenue Code. 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.

Furthermore, the Exchange proposes to adopt an exception for inducement grants to new employees because, in these cases, a company has an arm's length relationship with the new employees, and its interests are directly aligned with the shareholders. This exception would apply to persons previously employed by the issuer following a bona fide period of non-employment. In addition, for these purposes, inducement grants would include grants of options or stock to new employees in connection with a merger or acquisition. The proposal would require that, 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 shares involved.

In addition, the proposal would provide that plans involving a merger or acquisition would not require shareholder approval in two situations. First, the Exchange will not require shareholder approval to convert, replace or adjust outstanding options or other equity compensation awards to reflect the transaction. Second, the shares available under certain plans acquired in corporate acquisitions and mergers may be used for certain post-transaction grants without further shareholder approval. This exception would apply 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. 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. 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 will not result in any increase in the aggregate potential dilution of the combined enterprise.

Under the Exchange's proposal, inducement grants, tax qualified, non-discriminatory benefit plans, and parallel nonqualified plans are subject to approval by either the issuer's independent compensation committee, or a majority of the issuer's independent directors. The Exchange also notes that a company would not be permitted to use repurchased shares to fund options without prior shareholder approval. 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 Exchange proposal further clarifies that material amendments to plans would require shareholder approval. The accompanying proposed "Commentary" 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 generally be required.⁵ Certain provisions in a plan, however, cannot be amended without shareholder approval. For example, stock option plans that contain 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. 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.

The proposed "Commentary" also provides that, as a general matter, when preparing plans and presenting them for

⁵ The Exchange 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.