November 11, 2002

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: Self-Regulatory Organizations Proposed Rules Relating to Shareholder Approval of Equity Compensation Plans
File Nos. SR-NYSE-2002-46; SR-NASD-2002-140

Dear Mr. Katz:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities of the American Bar Association's Business Law Section (the "Committee")[*] in response to the Commission's request for written comments on proposed rules filed by the New York Stock Exchange, Inc. (the *"NYSE"*) on October 7, 2002 (the *"NYSE Proposal*") and The Nasdaq Stock Market (the *"Nasdaq"*) on October 9, 2002 (the "*Nasdaq Proposal*") relating to shareholder approval of equity compensation plans (collectively, the *"Proposals"*). These Proposals are set forth in Release Nos. 34-46620; 34-46649 (October 8, 2002 and October 11, 2002, respectively). This letter recommends specific changes to clarify and to conform the Proposals.

The comments expressed in this letter represent the views of the Committee only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and therefore do not represent the official position of the Association. In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committee.

[*] References in this letter to "we" and "our" mean the Committee.

A. Scope of Coverage

Although there may be instances where the NYSE and Nasdaq choose to have different standards, it is important that those choices be deliberate rather than inadvertent. The Proposals currently have a slightly different scope of coverage with respect to participants in equity compensation plans or award arrangements. It is important either to confirm that they are different or, preferably, harmonize them.

The NYSE Proposal, by implication from footnote 6, applies to equity compensation plans under which "employees, directors or service providers" can obtain company stock. In contrast, the Nasdaq Proposal covers equity awards to "officers, directors, employees [and] consultants." It would be helpful to clarify that the Proposals apply to plans that provide for grants and awards to employees or non-employees in exchange for consideration in the form of goods or services as described in Statement of Financial Accounting Standards No. 123. That standard was the one followed in Item 201(d) of Regulation S-K requiring annual disclosure of equity compensation plans and that same standard is appropriate here.

B. Conformity and Clarification of Exception for Inducement Awards

The Proposals provide for an exception to the shareholder approval requirement for inducement awards. The inducement award exception recognizes that requiring shareholder approval of all equity awards, including equity awards to new employees, could unnecessarily impede the ability of issuers to compete for and secure the services of talented individuals. The Nasdaq Proposal should be modified to conform to the NYSE Proposal with respect to who may be the recipient of an inducement award.

Currently, the inducement award exception contained in each of the Proposals differs with respect to the availability of the exception for awards to new employees who are current or former directors of the issuer. The Commentary to the NYSE Proposal makes clear that it would permit inducement awards for new employees who have served on the issuer's board of directors.[1] In contrast, under the Nasdaq Proposal, the inducement award exception is applicable "for issuances to a person not previously an employee or director of the company."

The Nasdaq Proposal should be modified to conform to the NYSE Proposal and should be applied without regard to whether the new employee has previously been or currently is a director of the issuer.

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[1] It is not uncommon for outside directors to be selected to fill executive positions and several prominent issuers have requested board members to assume chief executive officer positions.

C. Exceptions for Section 401(a) and Section 423 Plans

The NYSE Proposal excepts from the shareholder approval requirement equity compensation plans that are "intended to meet" the requirements of Section 401(a) or Section 423 of the Internal Revenue Code of 1986, as amended (the *"Code"*). The Nasdaq Proposal excepts from the shareholder approval requirement equity compensation plans that "meet" the requirements of Sections 401(a) and Section 423 of the Code. Because some plans that are intended to meet the requirements of Section 401(a) of the Code may fail to satisfy each and every one of the technical and complex requirements of that section, the Nasdaq Proposal should be conformed to the NYSE Proposal by stating that the proposed exception would apply to plans that are "intended to meet" the requirements of Code Section 401(a). In addition, some issuers maintain non-discriminatory employee stock purchase plans that cannot qualify under Section 423 of the Code because they cover employees of employers that are not organized as corporations or are less than 50% subsidiaries of the issuer, but which plans do satisfy the non-discriminatory coverage requirement of Section 410 of the Code. These non-discriminatory plans, like those that meet the Section 423 non-discrimination requirements, should be exempt from the Proposals' shareholder approval requirement. It is recommended that the reference to Section 423 plans in the Proposals be changed to "stock purchase plans" within the definition of subsection (b)(5) of Rule 16b-3 adopted under Section 16 of the Securities Exchange Act of 1934 (*"Rule 16b-3"*). Rule 16b-3(b)(5) defines "stock purchase plans" to include plans that satisfy the coverage and participation requirements of Sections 423(b)(3) and 432(b)(5), or Section 410, of the Code.

D. Evergreen Formula Plans

The NYSE Proposal in footnote 8 provides that an automatic increase in the shares available under an equity compensation plan pursuant to an evergreen formula provision will not be considered a "material revision" of an equity compensation plan "if the term of the plan is limited to a specified period of time not in excess of ten years." There is no legal requirement that an equity compensation plan contain a provision that limits the term of the plan and many plans contain no such provision. It is appropriate for the NYSE Proposal to provide transition relief to such plans that contain evergreen formula provisions by revising footnote 8 of the NYSE Proposal to provide that evergreen increases would not be deemed to be "material revisions" until the earliest of (i) a subsequent material revision of the plan, (ii) the expiration of the term of the plan, and (iii) the later of (a) ten years from the date the plan was adopted and (b) five years from the effective date of the NYSE Proposal.

The Nasdaq Proposal provides no guidance with respect to its application to equity compensation plans that contain evergreen formula provisions. The Nasdaq Proposal should be conformed to the NYSE Proposal with respect to the provisions relating to evergreen formulas in plans.

E. Parallel Nonqualified Plan Definition

The proposed definition of "parallel nonqualified plans"[2] in the Proposals is substantially similar to the definition of "excess benefit plan" of Rule 16b-3.[3] Issuers maintain plans ("*Make Up Plans"*) that are designed to provide contributions or benefits that cannot be provided under tax-qualified plans because of the various rules and limitations imposed by the Employee Retirement Income Security Act of 1974, as amended (*"ERISA"*) and the Code. Issuers are generally familiar with the application of Rule 16b-3 and structure their Make Up Plans to meet the Rule 16b-3 definition of "excess benefit plan."

The policy basis for exempting certain transactions in "excess benefit plans" under Rule 16b-3 and for exempting "parallel nonqualified plans" from the shareholder approval requirement are similar; that is, tax-qualified plans are subject to a complex regulatory scheme under ERISA and the Code. They typically provide benefits in proportion to compensation and are required to be broad-based. Thus, they are unlikely to be used as short-swing trading vehicles or to dilute shareholders' interests for the primary benefit of executive officers and directors. It would be appropriate to use the same defined term to describe Make Up Plans in both Rule 16b-3 and the Proposals.

Having the same definition in both Rule 16b-3 and in the Proposals would make it simpler for issuers to recognize whether a plan satisfied the requirements of the rules, and would save time in regulatory administration, by allowing interpretive advice to apply both for purposes of Rule 16b-3 and for the shareholder approval requirement. The definition of "excess benefit plan" under Rule 16b-3 has been interpreted by the Securities and Exchange Commission (the *"SEC"*).[4] Because the policy purposes for exempting Make Up Plans are substantially the same for both Rule 16b-3 and the proposed shareholder approval requirements contained in the Proposals, it serves no useful purpose to have two different definitions, requiring

[2] The definition is found in footnote 13 to the NYSE Proposal and in footnote 1 to the Nasdaq Proposal

[3] The definition of "excess benefit plan" set for in the Rule 16b-3 is substantially similar to the Proposals' definition of "parallel nonqualified plan." Rule 16b-3(b)(2) defines an "excess benefit plan" as an employee benefit plan that is operated in conjunction with a Section 401(a) plan, and provides only the benefits or contributions that would be provided under a Section 401(a) plan but for any benefit contribution limitations set forth in the Code.

[4] There have been several interpretive letters addressing the scope of Rule 16b-3's definition of "excess benefit plans" and other issues surface from time to time requiring SEC staff resources in handling inquiries and issuing interpretive advice with respect to the Rule's exemption. *See*, *e.g.*, American Society of Corporate Secretaries (December 11, 1996) (Q.4); American Express Company (February 26, 1997); American Bar Association (February 10, 1999) (Q.2).

more administrative resources than any distinction merits. It is recommended that the definition of "parallel nonqualified plan" in the Proposals be modified to conform to the definition of "excess benefit plan" contained in Rule 16b-3.[5]

F. Foreign Plans of Listed Domestic Issuers

In its Commentary, the NYSE Proposal provides:

> "Equity compensation plans that would qualify for the exception described in this paragraph but for features necessary to comply with foreign tax law in the non-U.S. jurisdiction in which the employees covered by the plan reside, are also exempt from shareholder approval under this section."

Presumably, the Commentary was meant to cover plans of listed domestic issuers who maintain equity compensation plans for their employees in foreign jurisdictions, provided that the features of the plan differ from a U.S. tax qualified plan only as necessary to comply with the foreign tax law of the non-U.S.

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[5] The Proposals' current "parallel nonqualified plan" definition is also problematic in that certain Make Up Plans will not be able to satisfy the current requirement that such plans must cover substantially all employees with compensation over the limitation in Code Section 401(a)(17) (the *"Compensation Threshold"*). Meeting the Compensation Threshold requirement will in some cases cause a Make Up Plan to violate ERISA. To avoid adverse tax consequences, a Make Up Plan must be a so-called "top hat" plan under ERISA. It will be a top hat plan only if it is maintained "for a select group of management or highly compensated employees." ERISA Sections 201, 301 and 401. The U.S. Department of Labor, which has enforcement jurisdiction over top hat plans, as well as numerous courts, have interpreted the meaning of both "select group" and "highly compensated." It is clear that no bright line rule applies and that each plan will be judged on its own facts and circumstances. Thus, while employees who earn over the Compensation Threshold may qualify as a top hat group for one issuer, they would not qualify for another issuer. A plan covering all employees who earn in excess of the Compensation Threshold will not necessarily meet the "select group" or "highly compensated" requirement to be an ERISA top hat plan. Thus, ERISA rules constrain issuers in some cases to limit participation in their Make Up Plans to employees who earn substantially more than the Compensation Threshold.

jurisdiction in which the employees covered by the plan reside.[6] However, these plans are also designed to comply with foreign company, labor and national insurance laws as well as to meet different cultural attitudes of the foreign jurisdiction.

It is recommended that the NYSE Proposal be modified to provide:

"Equity compensation plans covering employees residing in a non-U.S. jurisdiction that are designed to comply with local foreign tax laws and under which all full-time employees are, in general, eligible to participate subject to certain service, age or other requirements permitted under the foreign jurisdiction's law should be exempt from shareholder approval under this section" (language underscored to highlight recommended change).

Many equity compensation plans currently covering employees residing in a non-U.S. jurisdiction are funded with issuer shares purchased on the open market and do not contain any provision limiting the number of shares which may be purchased under the plan. Although some of these plans may not be deemed "equity compensation plans" in accordance with footnotes to the NYSE Proposal, many such plans provide an issuer matching share feature or an additional savings feature and would, therefore, not meet the exception for open market plans described in the footnote. Under current NYSE rules, these plans have not required shareholder approval because they did not cover directors or executive officers or because they relied on the treasury stock exemption.

The NYSE Proposal should provide transition relief to equity compensation plans of listed domestic issuers (and their affiliates) covering employees residing in a non-U.S. jurisdiction which plans were in effect prior to the effective date of the NYSE Proposal even where the plan does not contain a specific number of shares available under the plan until the earliest of (i) a subsequent material revision of the plan, (ii) the expiration of the term of the plan, and (iii) the later of (a) ten years from the date the plan was adopted and (b) five years from the effective date of the NYSE Proposal. It is recommended that the Nasdaq Proposal be conformed in a similar manner.

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[6] Although plans covering non-U.S. employees are typically designed to comply with local foreign tax law, they may differ from tax qualified plans in certain respects other than only in those respects that the local tax law differs from Internal Revenue Code requirements for U.S. plans. For example, in the United Kingdom ("U.K.") there are at least four types of Inland Revenue approved or designed schemes under which employees can obtain shares of the issuer and received favorable income tax treatments from the U.K. Inland Revenue: discretionary share option schemes, savings-related share option schemes ("SAYE"), Share Incentive Plans and Enterprise Management Incentive Schemes. It is not clear which of these U.K. plans would qualify as exempt from the NYSE shareholder approval requirements.

G. Conformity and Clarification Regarding Actions Constituting Material Revisions or Material Amendments to Equity Plans

The Proposals require shareholder approval of "material revisions" or "material amendments" to equity compensation plans. Pursuant to the Commentary of the NYSE Proposal, "any material revision to the terms of [an equity-compensation] plan must be approved by shareholders." The Commentary then sets forth various examples of "material revisions," but indicates that the list is not exhaustive.[7] The Nasdaq Proposal provides that shareholder approval is required if a stock option or stock purchase plan is "materially amended." Although it does not set forth what amendments are considered to be material, the Nasdaq Proposal notes that the Nasdaq will "continue to provide guidance" on the issue and currently determines an amendment's materiality under the factors used to determine materiality for purposes of the former Rule 16b-3.[8]

It is recommended that the term "material revisions" be defined with specificity in the text of the NYSE Proposal and that the term "materially amended" be defined with specificity in the Nasdaq Proposal. Underlying this belief is concern that adoption of a rule not enumerating the plan amendments (or revisions) considered "material" would result in the on-going need for the NYSE and Nasdaq to provide interpretive advice on materiality that would tax the resources of the NYSE, Nasdaq and issuers unnecessarily.[9] Uncertainty in this area could greatly limit the ability of issuers to administer and refine their equity plans. To this end, the only revisions (or amendments) to a plan that should be deemed "material" are those that would result in changes: (i) to increase the number of shares covered (other than pursuant to an evergreen provision providing for a numerical or percentage increase in shares that has been previously approved by shareholders or pursuant to a reorganization, stock split, merger, spinoff or similar transaction) (ii) to reduce the price at which shares or options to purchase shares may be offered; (iii) to change the types of awards that may be offered under the plan; (iv) to increase the number of

[7] Specifically, the Commentary provides that "a 'material revision' would include, but not be limited to, a revision that: materially increases the number of shares available under the plan (other than an increase solely to reflect a reorganization, stock split, merger, spinoff or similar transaction); changes the types of awards available under the plan; materially expands the class of persons eligible to receive awards under or otherwise participate in the plan; materially expands the class of persons eligible to receive awards under or otherwise participate in the plan; materially extends the term of the plan; or materially changes the method of determining the strike price of options under the plan."

[8] Those factors include "whether there is a material change to: (1) The benefits available to potential recipients under the plan; (2) the number of shares available under the plan; or (3) the class of eligible participants under the plan."

[9] It is notable that during the first two years following the 1991 revision of Rule 16b-3 to require shareholder approval of "material amendments" to plans, the SEC found it necessary to issue 48 interpretive letters regarding the need for shareholder approval of such plan amendments.

shares that may be granted or sold to any officer or director under the plan; (v) to expand the class of eligible participants; (vi) to specifically permit a repricing (or decrease in exercise price) of options; or (vii) to extend the duration of the plan. These items are well defined, generally viewed as material by issuers, and consistent with prior opinions on materiality issued by the SEC in relation to Rule 16b-3.

Separately, the Proposals should conform with respect to whether any approval is required for plan amendments that do not require shareholder approval. The Comments to the NYSE Proposal make clear that where amendments to plans "are not subject to shareholder approval, … the amendments still must be subject to the approval of the company's compensation committee or a majority of the company's independent directors." There is no reason to require that amendments to plans qualifying under Code Section 401(a) or employee stock purchase plans be approved by the compensation committee or a majority of the independent directors. Such plans are already subject to a complex regulatory scheme. It is recommended that the NYSE Proposal be limited to amendments to plans (other than those qualifying under Code Section 401(a) or employee stock purchase plans) in the context of corporate mergers and acquisitions. It is recommended that the Nasdaq Proposal be conformed to the NYSE Proposal (as proposed to be revised) in this respect.

H. Stock Option Repricing as a Material Amendment

The Proposals currently differ in their treatment of "repricings." The NYSE Proposal expressly classifies a stock option repricing as a material revision of a plan if the plan "does not contain a provision that specifically permits repricing of options." The NYSE Proposal also provides that revising a plan to delete or limit the scope of an existing provision prohibiting a repricing of stock options constitutes a material revision. The Nasdaq Proposal makes no mention of how repricings should be treated.

This letter takes no position on which approach is more appropriate, and it may be that a separate approach by each of the NYSE and Nasdaq in this area is warranted. However, the NYSE Proposal should be modified to provide that the treatment of a "repricing" as a "material revision" of a plan should be mandated only in the case of newly adopted plans or plans that have had "material revisions" after the effective date of the NYSE Proposal. This treatment would be consistent with the treatment of shares reserved as of the effective date of the NYSE Proposal.

I. Specify the Requirements in the Text of the Proposals

It is recommended that the NYSE Proposal be modified such that the substantive requirements appear in the rule's text rather than only in the Commentary or footnotes. The following are but some of the important provisions

not addressed in the rule's text: (i) the requirement of shareholder approval for material revisions to plans; (ii) the definition of equity compensation plan; (iii) the qualifications to the inducement award exception; (iv) the qualifications to the exception for plans relating to mergers; (v) the exception for foreign plans; and (vi) the requirement of approval by the compensation committee or independent directors where shareholder approval is not required. The NYSE Proposal, like the Nasdaq Proposal, should specify the significant and substantive components of the rule in the rule's text.

J. The Elimination of Broker Voting

The NYSE Proposal, in Rule 452, precludes its member organizations from giving a proxy to vote on equity compensation plans unless the beneficial owner of the shares has given voting instructions. The rule explains that "generally speaking" proxies may not be given absent such specific voting instructions "when the matter to be voted upon authorizes the implementation of any equity compensation plan, or material revision to the terms of any existing equity compensation plan (whether or not stockholder approval of such plan is required . . .." The NYSE Proposal should specify when this new rule will be effective and provide a reasonable transition period. Many issuers have or will have proxy solicitation material outstanding before the date the NYSE Proposal is adopted in its final form. Such solicitations should not be disrupted.

Additionally, because issuers will face a significant challenge in securing the votes necessary for equity compensation plan actions that do not permit broker voting, it is important that the NYSE Proposal set forth whether there are any equity compensation plan matters on which broker voting is not prohibited absent specific instructions from the share owners Currently, the limitation on broker voting is qualified by the word "generally" and gives the impression that there are certain shareholder actions with respect to equity compensation plans that would not be limited.

We appreciate the opportunity to comment on the Proposals, and would be pleased to discuss any questions the Commission may have with respect to this letter. Any questions about this letter may be directed to Stanley Keller (617) 239-0217 or Scott P. Spector (650) 858-7251.

Very truly yours,

Stanley Keller
Chair, Committee on Federal
Regulation of Securities

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