



RULE  
ADOPTION  
NOTICE

**RAN-03-32**  
**November 12, 2003**

**TO: All PCX Members and Member Organizations  
ETP Holders and Sponsored Participants**

**FROM: Department of Regulatory Policy**

**SUBJECT: Listed Companies Shareholder Approval Policy for Equity  
Compensation Plans  
(File No. SR-PCX-2003-50)**

On September 22, 2003 the Pacific Exchange, Inc. filed with the Securities and Exchange Commission a proposal to adopt new rules relating to its shareholder approval policy for listed companies regarding stock option plans and other equity compensation arrangements. On October 31, 2003 the Commission granted accelerated approval to the PCX's proposed rule change.

The following is the text of the rule change. Questions regarding this bulletin may be directed to Steven Matlin at (415) 393-4084.

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#### **EXHIBIT A**

### **PCX Equities, Inc.**

#### **Text of the Proposed Rule Change:<sup>1</sup>**

##### **Rule 5 Listings**

Rules 5.1 – 5.2 – No change.

#### **Section 3. Corporate Governance and Disclosure Policies** **Corporate Governance and Disclosure Policies**

Rule 5.3 – No Change.

Rule 5.3(a) – 5.3(c) – No Change.

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<sup>1</sup> New text is underscored; deleted text is in brackets.

## Shareholder Approval Policy

### Rule 5.3(d) Shareholder Approval Policy

Each issuer shall require shareholder approval of a plan or arrangement pursuant to [under] subparagraphs (1) through (7) below or, prior to the issuance of designated securities under subparagraphs (8) [(2)] through (11) [(4)] below. [, when:]

(1) Shareholder Approval. Except as provided for in this Rule 5.3(d) all equity-compensation plans, and any material revisions to the terms of such plans, must be approved by the shareholders of the listed company. [A stock option or purchase plan is to be established or other arrangement made pursuant to which stock may be acquired by officers or directors, except for warrants or rights issued generally to security holders of the company or broadly based plans or arrangements including other employees (e.g., ESOPs).

The Corporation will generally not require shareholder's approval as a condition to listing shares reserved for the exercise of options when:

(i) such options are issued to an individual, not previously employed by the company, as an inducement essential to the individual's entering into an employment contract with the company provided that the potential issuance of shares pursuant to such options does not exceed 5% of the company's outstanding common stock; or

(ii) the establishment of a plan or arrangement under which the amount of securities which may be issued does not exceed the lesser of 1% of the number of shares outstanding common stock, 1% of the voting power outstanding, or 25,000 shares and provided that all arrangements adopted without shareholder approval in any five-year period do not authorize, in the aggregate, the issuance of more than 10% of outstanding common stock or voting power outstanding. (For the purpose of calculating the percentage of stock issued in aggregate, stock to be issued pursuant to options which have expired and/or been cancelled shall not be included.)

(2) Equity Compensation Plan Defined. An equity compensation plan is a plan or other arrangement that provides for the delivery of equity securities (either newly issued or treasury shares) of the listed company to any employee, director or other service provider as compensation for services. For purposes of this rule, a compensatory grant of options or other equity securities that is not made under a plan is, nonetheless, an equity compensation plan.

(A) Exceptions. The following are not equity compensation plans even if the brokerage and other costs of the plan are paid for by the listed company:

(i) Plans that are made available to shareholders generally, such as a typical dividend reinvestment plan.

(ii) Plans that merely allow employees, directors or other service providers to elect to buy shares on the open market or from the listed company for their current fair market value, regardless of whether:

(a) the shares are delivered immediately or on a deferred basis; or

(b) the payments for the shares are made directly or by giving up compensation that is otherwise due (for example, through payroll deductions).

(3) Material Revisions. A material revision of an equity compensation plan includes, but is not limited to, the following:

(A) A material increase in the number of shares available under the plan (other than an increase solely to reflect a reorganization, stock split, merger, spinoff or similar transaction).

(i) 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 formula, each such increase or grant will be considered a revision requiring shareholder approval unless the plan has a term of not more than ten years.

This type of plan (regardless of its term) is referred to as a formula plan. Examples of automatic grants pursuant to a formula plan are:

(a) annual grants to directors of restricted stock having a certain dollar value; and

(b) matching contributions, whereby stock is credited to a participant's account based upon the amount of compensation the participant elects to defer.

(ii) If a plan contains no limit on the number of shares available and is not a formula plan, then each grant under the plan will require separate shareholder approval regardless of whether the plan has a term of not more than ten years.

This type of plan is referred to as a discretionary plan. A requirement that grants be made out of treasury shares or repurchased shares will not, in itself, be considered a limit or preestablished formula so as to prevent a plan from being considered a discretionary plan.

(B) An expansion of the types of awards available under the plan.

(C) A material expansion of the class of employees, directors or other service providers eligible to participate in the plan.

(D) A material extension of the term of the plan.

(E) A material change to the method of determining the strike price of options under the plan.

(F) The deletion or limitation of any provision prohibiting repricing of options.

An amendment will not be considered a Material Revision if it curtails rather than expands the scope of the plan in question.

(4) Repricings. Repricing means any of the following or any other action that has the same effect:

(A) Lowering the strike price of an option after it is granted.

(B) Any other action that is treated as a repricing under generally accepted accounting principles.

(C) Canceling an option at a time when its strike price exceeds the fair market value of the underlying stock, in exchange for another option, restricted stock, or other equity, unless the cancellation occurs in connection with a merger, acquisition, spin-off or other similar corporate transaction.

A plan that does not contain a provision that specifically permits repricing of options will be considered for purposes of this rule as prohibiting repricing. Therefore, any actual repricing of options will be considered a material revision of a plan even if the plan itself is not revised. This consideration will not apply to a repricing through an exchange offer that commenced before the date this rule became effective.

(5) Exemptions. This rule does not require shareholder approval of employment inducement awards, certain grants, plans and amendments in the context of mergers and acquisitions, and certain specific types of plans, as described below. These exempt grants, plans and amendments may be made only with the approval of the listed company's independent compensation committee or the approval of a majority of the company's independent directors. Listed companies must notify the Exchange in writing when they use these exemptions.

(A) Employment Inducement Awards. An employment inducement award is a grant of options or other equity based compensation as a material inducement to a person or persons being hired by the listed company or any of its subsidiaries, or being rehired following a bona fide period of interruption of employment. Inducement awards include grants to new employees in connection with a merger or acquisition. Promptly following a grant of any inducement award in reliance of this exemption, the listed company 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.

(B) Mergers and Acquisitions. In the context of corporate acquisitions and mergers, the following exemptions apply:

(i) Shareholder approval is not required to convert, replace or adjust outstanding options or other equity compensations awards to reflect the transaction.

(ii) Shares available under certain plans acquired in corporate acquisitions and mergers may be used for certain post-transaction grants without further shareholder approval. This exemption applies where a 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. A plan adopted in

contemplation of the merger or acquisition transaction would not be considered pre-existing for purposes of this exemption.

Shares available under a pre-existing plan may be used for post-transaction grants of options and other awards with respect to equity of the entity that is the listed company after the transaction, either under the pre-existing plan or another plan, without further shareholder approval, so long as:

(a) the number of shares available for grants is appropriately adjusted to reflect the transaction;

(b) the time during which those shares are available is not extended beyond the period when they would have been available under the pre-existing plan, absent the transaction; and

(c) the options and other awards are not granted to individuals who were employed, immediately before the transaction, by the post-transaction listed company or entities that were its subsidiaries immediately before the transaction.

Any shares reserved for listing in connection with a transaction pursuant to either of these exemptions would be counted by the Exchange in determining whether the transaction involved the issuance of 20% or more of the company's outstanding common stock and thus requires shareholder approval pursuant to Rule 5.3(d)(9)(B).

(D) Qualified Plans, Parallel Excess Plans and Section 423 Plans. The following types of plans, and material revisions thereto, are exempt from the shareholder approval requirement:

(i) plans intended to meet the requirement of Section 401(a) of the Internal Revenue Code (e.g. ESOP);

(ii) plans intended to meet the requirements of Section 423 of the Internal Revenue Code;

(iii) parallel excess plans. A parallel excess plan is a plan that is a pension plan within the meaning of the Employee Retirement Income Security Act that is designed to work in parallel with a plan intended to be qualified under Internal Revenue Code Section 401(a) to provide benefits that exceed the limits set forth in Internal Revenue Code Section 402(g) (the section that limits the contributions and benefits under qualified plans), Internal Revenue Code Section 401(a)(17) (the section that limits the amount of an employee's compensation that can be taken into account for plan purposes) and/or Internal Revenue Code Section 415 (the section that limits the contributions and benefits under qualified plans) and/or any successor or similar limitations that may hereafter be enacted.

A plan will not be considered a parallel excess plan unless:

(a) it covers all or substantially all employees of an employer who are participants in the related qualified plan whose annual compensation is in excess of the limit of Internal Revenue Code Section 401(a)(17) or any successor or similar limits that may hereafter be enacted;

(b) its terms are substantially the same as the qualified plan that it parallels except for the elimination of the limits described in the preceding sentence and the limitation described in clause (c) below; and

(c) no participant receives employer equity contributions under the plan in excess of 25% of the participant's cash compensation.

(iv) an equity compensation plan that provides non-U.S. employees with substantially the same benefits as a comparable Section 401(a) plan, Section 423 plan or parallel excess plan that the listed company 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.

(6) Transition Rules. Except as provided below, a plan that was adopted before the date of the Securities and Exchange Commission order approving this rule will not be subject to shareholder approval under this section unless and until it is materially revised.

In the case of a discretionary plan, as defined in Rule 5.3(d)(3)(A)(ii), whether or not previously approved by shareholders, additional grants may be made after the effective date of this rule without further shareholder approval only for a limited transition period, defined below, and then only in a manner consistent with past practice. In applying this rule, if a plan can be separated into a discretionary plan portion and a portion that is not discretionary, the non-discretionary portion of the plan can continue to be used separately, under the appropriate transition rule. For example, if a shareholder approved plan permits both grants pursuant to a provision that makes available a specific number of shares, and grants pursuant to a provision authorizing the use of treasury shares without regard to the specific share limit, the former provision (but not the latter) may continue to be used after the transition period, under the general rule.

In the case of a formula plan, as defined in Rule 5.3(d)(3)(A)(i), that either has not previously been approved by shareholders or does not have a term of ten years or less, additional grants may be made after the effective date of this rule without further shareholder approval only for a limited transition period defined below.

The limited transition period will end upon the first to occur of:

(A) the listed company's next annual meeting at which directors are elected that occurs more than 180 days after the effective date of this rule;

(B) the first anniversary of the effective date of this rule; and

(C) the expiration of the plan.

A shareholder approved formula plan may continue to be used after the end of this transition period if it is amended to provide for a term of ten years or less from the date of its original adoption or, if later, the date of its most recent shareholder approval. Such an amendment may be made before or after the effective date of this rule, and would not itself be considered a material revision requiring shareholder approval.

A formula plan may continue to be used, without shareholder approval, if the grants after the effective date of this rule are made only from the shares available immediately before the effective date, in other words, based on formulaic increases that occurred prior to such effective date.

(7) Broker Voting. The Exchange will preclude its ETP Holders from giving a proxy to vote on equity compensation plans unless the beneficial owner of the shares has given voting instructions. This is codified in Rule 9.4 (Proxy Voting). Amended Rule 9.4 will be effective for any meeting of shareholders that occurs on or after the 90<sup>th</sup> day following the date of the Securities and Exchange Commission order approving the rule change.

(8)[(2)] The issuance will result in a change of control of the issuer.

(9)[(3)] In connection with the acquisition of the stock or assets of another company, shareholder approval is needed in the following circumstances:

(A)[(i)] if any director, officer, or substantial shareholder of the listed company has a 5% or greater interest (or such persons collectively have a 10% or greater interest), directly or indirectly, in the company or assets to be acquired or in the consideration to be paid in the transaction (or series of related transactions) and the present or potential issuance of common stock, or securities convertible into or exercisable for common stock, could result in an increase in outstanding common shares or voting power of 5% or more; or

(B)[(ii)] where the present or potential issuance of common stock, or securities convertible into or exercisable for common stock (other than in a public offering for cash), could result in an increase in outstanding common shares of 20% or more or could represent 20% or more of the voting power outstanding before the issuance of such stock or securities.

(10)[(4)] In connection with a transaction other than a public offering involving:

(A)[(i)] the sale or issuance by the company of common stock (or securities convertible into or exercisable for common stock) at a price less than the greater of book or market value, which together with sales by officers, directors or principal shareholders of the company equals 20% or more of presently outstanding common stock, or 20% or more of the presently outstanding voting power; or

(B)[(ii)] the sale or issuance by the company of common stock (or securities convertible into or exercisable for common stock) equal to 20% or more of presently outstanding stock or voting power for less than the greater of book or market value of the stock.

(11)[(5)] Exceptions may be made upon application to the Corporation when:

(A)[(i)] the delay in securing shareholder approval would seriously jeopardize the financial viability of the enterprise; and

(B)[(ii)] reliance by the company on this exception is expressly approved by the audit committee of the board or a comparable body.

A company relying on this exception must mail to all shareholders, no later than ten days before issuance of the securities, a letter alerting them to its omission to seek the shareholder approval that would otherwise be required and indicating that the audit committee of the board or a comparable body has expressly approved the exception.

*Commentary:*

.01 – .02 – No Change.

Rule 5.3(e) – 5.3(o) – No Change.

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## Rule 9

### CONDUCTING BUSINESS WITH THE PUBLIC

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#### Proxies Voting

Rule 9.4. No ETP Holder shall give a proxy vote that 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 5.3(d)(1)-(7)), unless the beneficial owner of the shares has given voting instructions. This provision for equity compensation plans shall be effective for any meeting of shareholders that occurs on or after the 90<sup>th</sup> day following the date of the Securities and Exchange Commission order approving the rule change. In all other matters besides equity compensation plans, no ETP Holder shall sign or give a proxy to vote any stock registered in the name or control of such ETP Holder unless (a) the ETP Holder is the actual owner thereof, (b) pursuant to the written instructions of such actual owner, or (c) pursuant to the rules of another national securities exchange to which he or she or his or her firm is responsible.

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