

SEC CHANGES POSITION ON RULE PERMITTING EXCLUSION OF SHAREHOLDER PROPOSALS RELATING TO CERTAIN EQUITY COMPENSATION PLANS

Summary

Citing increased public debate over the need for shareholder approval of equity compensation plans, the Securities and Exchange Commission (the “SEC”) has changed its position on a rule that had permitted public companies to exclude from their proxy statements shareholder-sponsored proposals requiring companies to obtain shareholder approval of such plans.¹ Under the new SEC position (which is effective immediately), companies may not exclude proposals requiring shareholder approval of equity compensation plans if such plans would potentially result in “material dilution” to shareholders. Companies had been permitted to exclude such proposals in reliance on Rule 14a-8(i)(7) under the Securities Exchange Act of 1934 (the “Exchange Act”), which allows companies to exclude proposals that relate to “ordinary business” matters.

Background

Rule 14a-8 under the Exchange Act allows shareholders who have held at least \$2,000 in market value of a public company’s securities for a continuous period of at least one year to submit proposals for inclusion in the company’s proxy statement. The rule also describes certain types of proposals that a company is permitted to exclude from its proxy statement. Rule 14a-8(i)(7) provides one basis for exclusion where the proposal relates to ordinary business matters.

The SEC has stated that proposals involving “the management of the workforce, such as the hiring, promotion and termination of employees” relate to ordinary business matters and, as such, may be properly excluded in reliance on Rule 14a-8(i)(7). The SEC’s position to date on equity compensation proposals has been consistent with this general guidance. In fact, during the 2001-2002 proxy season, the SEC issued four no-action letters allowing companies, in reliance on Rule 14a-8(i)(7), to exclude shareholder proposals requiring shareholder approval of equity compensation plans that would potentially result in material dilution to shareholders. The SEC concluded that the proposals could be excluded because they related to general employee compensation, an ordinary business matter. The SEC also expressed the view, however, that proposals relating to ordinary business matters but focusing on “sufficiently significant social policy issues” would not be excludable because such proposals would “transcend day-to-day business matters.” In this regard, the SEC has often noted that the presence of widespread public

¹ SEC Division of Corporate Finance: Staff Legal Bulletin No. 14A (July 12, 2002).

debate regarding a particular issue is a factor to consider in determining whether that issue “transcends day-to-day business matters,” in which case exclusion of the proposal would not be appropriate.

The SEC’s New Position

In light of the widespread public debate currently surrounding shareholder approval of equity compensation plans, the SEC is now of the view that shareholder proposals may not be excluded from proxy statements in reliance on Rule 14a-8(i)(7) if they require a company to obtain shareholder approval for equity compensation plans that would potentially result in material dilution to existing shareholders. Such proposals may not be excluded regardless of whether the plans are used to compensate senior executives, the general workforce, or both.² The SEC did not elaborate on what might constitute “material dilution” for this purpose, and we believe that further guidance will be needed on this topic.

Companies can expect activist shareholders to take advantage of the new SEC position, and thereby limit management’s ability to grant equity compensation without shareholder approval. Also, such proposals would be in addition to current NYSE and Nasdaq rules requiring shareholder approval of certain equity compensation plans. Both the NYSE and Nasdaq are in the process of adopting revisions to those rules that would further limit the ability of listed companies to adopt equity compensation plans without shareholder approval.

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Questions about the SEC’s new position can be addressed to Frank A. Daniele (212-728-8216) or J. Pasco Struhs (212-728-8109).

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² The SEC also reiterated its previous position that proposals may not be excluded in reliance on Rule 14a-8(i)(7) if they would require shareholder approval of equity compensation plans that are used to compensate only senior executive officers and directors.