



## Seeking Shareholder Approval of Equity-Based Incentive Plans Under the New NYSE/NASDAQ Listing Standards

by

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The New York Stock Exchange (NYSE) and NASDAQ have now adopted sweeping changes to their listing standards in an attempt to improve the corporate governance environment and restore trust in the market. Among them is the proposal to require that virtually all new or amended equity-based incentive plans be submitted to shareholders for approval, as well as the NYSE's proposed elimination of broker routine voting (the so-called "ten-day rule") as it applies to equity-based incentive plan proposals.

With these changes, senior managements and Boards of Directors will unfortunately lose considerable flexibility in managing compensation strategy for officers, directors and even rank-and-file employees. Both changes will seriously impact a company's ability to issue new options and other incentive awards in the face of growing pressure to reduce option "overhang" and limit potential dilution costs.

The result is that many companies will face the prospect of putting broad-based employee equity plans to a vote for the first time.

### Key NYSE/NASDAQ Listing Standards Affecting Equity Plans: Before and After\*

#### BEFORE

Exemption from vote requirement exists for certain broad-based employee plans.

Brokers may vote without customer instructions on equity-based plans or amendments to plans proposing less than 5% of shares outstanding under "ten-day rule."

#### AFTER

With few exceptions, all equity-based plans must be approved by shareholders.

"Ten-day rule" no longer applies to option plan votes. Brokers cannot vote customer shares without instructions.

*\*Certain differences exist between NYSE and NASDAQ rules exist*

According to recent statistics, the average S&P 500 Company now has an overhang of nearly 15%, including shares available for future grants, plus options outstanding and unexercised. That means the average company now has overhang that exceeds the total dilution guidelines of many of the largest institutional investors. Not surprisingly, opposition votes to equity-based incentive plans have risen to record levels in recent years, even though relatively few plans actually failed to pass when presented to shareholders for a vote. That may be about to change.

In the past, companies often relied on the practice of asking shareholders to vote every year or so on increases of less than 5% of shares outstanding for option awards. The use of “discretionary voting” allowed brokers to vote their customers’ uninstructed shares on these proposals under NYSE Rule 452. The brokerage community routinely votes these shares as management recommends. Just as importantly, the NYSE did not count overhang option shares towards the 5% threshold. Thus, a company with 25% dilution overhang could often pass an option plan in the face of significant opposition from its largest institutional investors, as long as a sufficient number of retail shares were voted by brokers. The advantage of this routine vote was not just the near unanimous support of brokers, but the almost doubling of the number of shares voted by retail shareholder accounts.

However, under the new rules, the broker discretion on equity-incentive plans is no longer available to companies (the last date for such a proposal was September 28, 2003).

As an example of the impact of the broker vote, consider this: Automated Data Processing® (ADP®) reports that for the “street name” accounts covered by its programs, the average response rate for corporate annual meetings during the 2002 proxy season was 88.9%. Actual shares returned accounted for 65.5%, with the remainder of the shares generated by routine broker votes. This means that on average 34.5% of shares in street name, equal to an average 30.6% of outstanding shares, failed to submit voting instructions – a measure of the problem faced by companies if the “ten-day” rule is eliminated.

A useful exercise for companies to assess the potential future impact of this rule change is to analyze the last vote taken on an equity plan vote (assuming the request for new shares was less than 5% at the time of the proposal). Analyze the vote as follows:

- Back out the total number of shares voted by brokers on the incentive plan proposal.
- Reduce the actual number of shares voted by brokers by roughly half (or more in some cases)
- Reduce the “Yes” votes cast by 10% to 15%
- Recalculate the total vote on the plan proposal

Now you should have a fair approximation of how well the same plan would have fared had the discretionary vote not been in place. The results will vary widely depending on the structure of a company’s shareholder base, and be aware that your shareholder base may have changed significantly since the last vote. Companies with higher institutional ownership will see less of a difference. However, other companies that have performed this test have found that plans that passed with a 60% or higher would have pass marginally, or not at all, if the vote were taken today.

#### *Impact of the Rule Changes on Stock Option Plan Solicitation Strategy*

The impact of these rule changes is that companies will need to develop and execute strategies that maximize both institutional and retail investor voting to gain the necessary approvals on new equity compensation plans or add shares to existing plans.

### *Institutional Voting and Solicitation Strategy*

The prohibition on non-shareholder approved broad-based plans, and the elimination of the “ten-day rule” on stock option plans, further increases power of institutional investors to exercise veto power over equity-based incentive plans. For companies that are already primarily owned by institutions, i.e., 75% or more of outstanding shares, this is nothing new. But for other companies, the change means they will need to be more knowledgeable about institutional voting policies with respect to stock plans. And in many cases, it means being proactive during the solicitation – management will need to contact portfolio managers, analysts and proxy committees – in order to gain institutional support.

In developing a communications strategy, keep the following factors in mind:

#### *Understand Dilution*

Dilution guidelines run the gamut from 5% of shares outstanding to 20% of shares outstanding, plus overhang. Not only are there a plethora of dilution limits, there are a number of different ways that shareholders calculate dilution. The analysis and calculation will vary from case to case based on the makeup of companies’ shareholders and the policies of key institutional shareholders.

#### *Institutional Voting Guidelines Vary; ISS Support Alone May Not be Enough*

While some index funds’ voting patterns correlate strongly with Institutional Shareholder Services (ISS), many active and passive managers do not consistently follow ISS’ “Shareholder Value Transfer”-based recommendations on plans. Institutions like Fidelity Investments, Capital Group, Wellington Management, California Public Employee Retirement System, TIAA-CREF, Legg Mason and Dimensional Fund Advisors are just a few examples of institutions that follow their own guidelines, often voting against plans even when ISS recommends in favor, and vice versa. Some of these institutions focus strongly on traditional dilution calculations, while others look at option burn rate and qualitative factors such as vesting terms and performance features.

Moreover, ISS now has real competition in the marketplace for the first time. Glass, Lewis and Co., a San Francisco-based start-up formed by former Wall Street lawyers and investment bankers has teamed with Investor Responsibility Research Corp to provide voting recommendations and voting agent services to the institutional market. With respect to incentive plans, the Glass, Lewis perspective is markedly different from ISS and often leads to opposing recommendations that can be a help or a hindrance. Glass, Lewis, like ISS focuses on plan costs, but also incorporates a “needs”-based analysis that incorporates option burn rates and per-employee costs.

#### *New Mutual Fund Proxy Voting Disclosure Rules Will Make Persuading Shareholders More Difficult*

While direct communication will become more important following the exchanges’ reforms, it won’t get any easier. In the past, direct communication from senior management alone was an effective strategy for getting certain fund managers to be flexible with their voting guidelines. And in many cases, it still is. However, beginning in 2004, mutual fund managers will have to disclose how they cast votes on proxy proposals. Getting some fund managers to “bend the rules” even for meritorious plans will likely be tougher, given that it will be clear to all when a manager has voted outside of his or her normal guidelines.

That doesn't mean the effort won't be worthwhile. It means communications, including proxy statement explanations of plan proposals and subsequent letters to shareholders and meetings with investors will have to be more effective. We encourage companies to do a better job of explaining their equity compensation strategy in support of proposed plans and amendments compared to the usual "boilerplate" found in traditional proxy statements. An excellent example is the recent incentive plan discussion General Mills incorporated in its September 2003 proxy statement (a proposal that received the support of 85% of votes cast including strong institutional support). In discussing the plan's objectives, General Mills dispensed with the usual mantra regarding "attracting and retaining executive talent" and set out clear objectives that shareholders could identify with, like reducing annual run rates, shifting away from reliance on options and eliminating the company's non-shareholder approved programs. In addition, it evaluated the effectiveness of its past incentive strategy in imbuing its employees with a performance-oriented culture through meaningful increases in stock ownership.

### *Retail Solicitation Strategy*

While the power of institutions to control the fate of option plans is expected to increase, solicitation of the retail investor will become more important for companies with a fairly balanced mix of retail/institutional ownership now that the "ten-day rule" for option plans has been eliminated. With overhangs approaching record levels, companies must face the reality that institutional support for their plans will be sharply divided even with aggressive institutional campaigns. In cases where the retail-to-institutional ownership ratio is 30% or more, the key to a successful vote may lie in the hands of retail investors. Without an aggressive solicitation effort, the average company sees considerably less than half of its retail shareholder votes cast on a non-routine option plan. An active retail communication strategy can dramatically improve response rates to the 60%-70% range.

As the market's upheaval continues, the basics of retail strategy are changing as well. Individual investors have experienced great losses in their portfolios, and therefore tried-and-true strategies of the past may be inadequate. As a result, we anticipate the following changes in retail solicitation:

- **Standard reminder mailings will have less impact.** Given the dissatisfaction of the average individual investor, we believe the standard "Your Vote is Important" reminder by itself will be less effective in increasing response rates, unless combined with targeted direct telephone solicitation to an appropriate range of shareholders. In the case of street name accounts, the standard reminder mailing is not a letter from the company to the shareholder. It is essentially a notice from the brokerage firm to a client that it cannot vote a client's shares without instructions. Future communications may require more substantive solicitation letters from the company to its investors encouraging support for option programs.
- **Electronic voting strategies will become more important.** As the need for retail investors to respond increases, companies will need to make it as easy as possible for shareholders to vote. Internet and telephone voting has been available to street name holders for years now, and more recently for record holders. More technology changes are afoot. For example, in 2000, Georgeson adapted its TeleVote™ service for corporate solicitations. Originally developed by us for use in mutual fund proxy campaigns, TeleVote permits a proxy solicitor to contact a retail investor, discuss the proposal(s) to be voted on, record the votes, send a confirmation to the investor and transmit the votes to ADP. This is an extraordinarily efficient and cost-effective vote-gathering tool that will play a significant role in our shifting solicitation strategy.

- **Strategic planning will be the key to a successful option plan solicitation under the proposed rules.** In order to arrive at the right solicitation strategy, companies should follow a five-step planning process:
  - 1) Analyze the shareholder base to understand the components of its ownership, e.g. institutional, retail, inside ownership, record holders, foreign ownership, employee plans.
  - 2) Identify specific institutions (being careful to correctly identify the entity with voting authority over the shares) and understand the option-plan voting guidelines of each.
  - 3) Evaluate equity-based plans in terms of the various dilution calculations and option pricing models, as well as other qualitative guidelines used by the institutions and their agents. Revise plan terms if necessary.
  - 4) Project expected and required voting results on proposed plans.
  - 5) Develop solicitation and communication strategies for institutional and retail holders.

At Georgeson, we will continue to track the progress of the changes in compensation voting and keep our clients apprised of new developments, as well as strategies for coping with these changes. If you have further questions, you may call (212) 440-9800 or your Georgeson account executive for additional information.

**You can reach David Drake with any questions by e-mailing [ddrake@gscorp.com](mailto:ddrake@gscorp.com)**

The logo for Georgeson, featuring the word "Georgeson" in a blue, serif font. The letter "G" is significantly larger and more stylized than the other letters, which are in a smaller, standard serif font.