McKenna Long & Aldridge LLP
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Information Advisory

July 30, 2002

Proposed Rules for Compensation Committees, Executive Compensation and Equity-Based Compensation Plans

Part 4 of a Series from the Corporate Group

This Advisory is the fourth in our series dealing with proposed and pending changes to regulations affecting public companies. This Advisory specifically addresses proposed changes to the compensation committee of the board of directors as well as to the rules regarding executive compensation and shareholder approval of equity-based compensation plans. We consider specifically the New York Stock Exchange ("NYSE") proposed changes to its listing requirements as recommended by its Corporate Accountability and Listing Standards Committee (the "NYSE Listing Committee"), The Nasdaq Stock Market, Inc. ("Nasdaq") proposals to change its corporate governance standards, The Business Roundtable's Principles of Corporate Governance and recommendations from the Council of Institutional Investors (the "Council").

Please refer to our **Corporate Responsibility Redefined Advisory** for information on how proposed rules become enacted through action by the Securities and Exchange Commission (the "SEC"), Congress or the self-regulatory organizations.

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IN THIS ADVISORY

NYSE RECOMMENDATIONS

On June 6, 2002, the NYSE Listing Committee formally adopted a set of proposals which would change certain rules regarding compensation. These recommendations are to be considered by the NYSE Board of Directors on August 1, 2002 and, if adopted, will be forwarded to the SEC for its approval.

ABOUT US

McKenna Long & Aldridge is a full-service law firm of nearly 400 lawyers and public policy advisors with offices in Atlanta, Denver, Los Angeles, Philadelphia, San Diego, San Francisco, Washington, DC and Brussels. Formed June 1, 2002 through the merger of Long Aldridge & Norman LLP and McKenna & Cuneo L.L.P., the firm provides business solutions in the areas of corporate law, government contracts, intellectual property and technology, complex litigation, public policy and regulatory affairs, real estate, environmental, energy and finance.

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Compensation Committees

The NYSE Listing Committee's proposal would require all NYSE-listed companies to have a compensation committee, comprised entirely of independent directors.[1] The existing NYSE-listing standards do not require that a listed company have a compensation committee.

The compensation committee must have a written charter, which must be posted on the company's website. The charter must specify that an annual performance evaluation of the committee will be conducted and the charter must address the committee's purpose, duties and responsibilities.

The compensation committee's purpose, at a minimum, must be to discharge the board's responsibilities relating to compensation of the company's executives and to produce an annual report on executive compensation for inclusion in the company's proxy statement.

The committee's duties and responsibilities, at a minimum, must be to: (i) make recommendations to the board of directors with respect to incentive compensation plans and equity-based plans; and (ii) review and approve corporate goals and objectives relevant to the Chief Executive Officer's compensation, evaluate the CEO's performance in light of the corporate goals and objectives and set the CEO's compensation level based upon this evaluation. In determining the long-term incentive component of CEO compensation, the NYSE Listing Committee recommends that the compensation committee consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the CEO in previous years.

The NYSE Listing Committee also recommends that the compensation committee charter address: member qualifications, appointment and removal; committee structure and operations; delegation of authority to subcommittees; and reporting to the board of directors. Further, the proposed NYSE rules specify that the compensation committee should have sole authority, without requiring full board action, to retain and terminate outside advisors, such as compensation consultants.

1. For further discussion of the proposed definition of "independent director", please refer to Advisory No. 3, titled "Proposed Changes to Audit Committee Functions and Standards."

Executive Compensation/Equity-Based Compensation Plans

The NYSE Listing Committee's proposals would give shareholders more opportunity to monitor and participate in the governance of their companies. Current NYSE rules permit companies to adopt stock option plans without shareholder approval in many instances. The proposed change would require that listed companies give shareholders the opportunity to vote on all equity-based compensation plans and any material revisions to the terms of such plans (including the repricing of existing options).

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The proposals also include the requirement that a broker may not vote its customer shares on any proposal relating to equity-based compensation plans unless the broker has the customer's instructions to do so. Under current NYSE listing standards, brokers are only prohibited from voting without customer instructions where the plan to be voted upon would authorize the issuance of stock in an amount exceeding 5% of the total amount of stock outstanding.

The NYSE Listing Committee has also recommended that the SEC be asked to consider requiring inclusion in the proxy statement of additional quantitative information regarding the potential valuation of awards that may be made under equity-based compensation plans.

NASDAQ RULES AND PROPOSALS

Compensation Committees

Nasdaq did not offer any specific proposals regarding compensation committees in its earlier submission to the SEC seeking approval of Nasdaq proposed rule changes. However, on July 25, 2002, Nasdaq announced an additional group of corporate governance proposals. While the substance of the proposals is not yet available, it appears that Nasdaq will require approval of executive officer compensation either by an independent compensation committee of the board of directors or by a majority of the board's independent directors.

Executive Compensation/Equity-Based Compensation Plans

The first Nasdaq proposal regarding executive compensation and equity-based compensation plans is more limited than the NYSE Listing Committee proposal in that it requires shareholder approval only for stock option plans in which officers or directors participate. In addition, the earlier Nasdaq proposal provides for several exceptions to the shareholder approval requirement. Shareholder approval is not required for (i) tax qualified, non-discriminatory benefit plans offered generally to all employees or (ii) inducement grants to new officers, including grants to new employees in connection with a merger or acquisition, if such grants are approved by either a compensation committee comprised solely of independent directors or a majority of the company's independent directors.
The proposed rule makes clear that pre-existing grants for plans assumed in a merger or acquisition are not covered by the rule. Under the proposal, however, a company would not be permitted to use repurchased shares to fund options to officers without prior shareholder approval.

In its July 25, 2002 announcement, however, Nasdaq indicated that it anticipates it will require shareholder approval for <u>all</u> stock option plans, although existing exemptions for employee stock purchase plans and inducement options would be retained. Until the substance of the new Nasdaq proposal is available, it is not possible to determine how much it will change the earlier proposal.

THE BUSINESS ROUNDTABLE'S PRINCIPLES OF CORPORATE GOVERNANCE

In May 2002, The Business Roundtable released its Principles of Corporate Governance ("Principles"), which is a set of guiding principles intended to assist corporate management and boards of directors in their efforts to implement corporate governance "best practices." The NYSE and Nasdaq have followed many of the Principles in their proposals.

Compensation Committees

As with the proposals of the NYSE Listing Committee, The Business Roundtable recommends that every publicly-owned company have a compensation committee comprised solely of independent directors that addresses compensation issues. Decisions about compensation committee membership should be made by the full board, based upon recommendations from the committee responsible for corporate governance issues. The compensation committee also should apprise the full board of its activities on a regular basis. The Business Roundtable believes that the company should develop procedures for keeping the board informed through oral or written reports.

The Principles propose that the compensation committees should: (i) oversee the company's overall compensation programs; (ii) assess whether the company has established appropriate incentives for management and employees at all levels; and (iii) set CEO and senior management compensation. The Principles recommend that, in assessing overall compensation, the committee use the following guidelines:

- all incentives should further the company's long-term strategic plan and should be consistent with the culture of the company and the overall goal of enhancing enduring shareholder value;
- a diverse mix of compensation for the board and management can foster the right incentives and prevent a short-term focus or narrow emphasis on particular aspects of the company's business;
- equity compensation for directors and management may align director and management interests with shareholder value, but should be carefully designed to avoid unintended incentives, such as an undue emphasis on short-term market value changes;
- an appropriate compensation package for management should include a carefully determined mix of long-term and short-term incentives and management compensation packages should be designed to create a commensurate level of risk and opportunity based upon business and individual performance; and
- the benefits provided to senior management, including post-employment benefits, should be proportional to the contributions made by management.

Executive Compensation/Equity-Based Compensation Plans

The Principles recommend that companies should obtain shareholder approval of new stock option and restricted stock plans in which directors or executive officers participate. The Principles also recommend that the compensation committee should set CEO and senior management compensation and oversee the company's overall compensation structure to assess whether it establishes appropriate incentives for directors, management and all employees.

COUNCIL OF INSTITUTIONAL INVESTORS

The Council provided testimony to the NYSE Listing Committee prior to the NYSE Listing Committee making its recommendation to the NYSE Board of Directors.

Compensation Committees

The Council stated that it, along with many leading investors in the institutional investor community, including CalPERS and TIAA-CREF, calls for compensation committees comprised entirely of independent directors.

Executive Compensation/Equity-Based Compensation Plans

The Council proposes that the stock exchanges adopt tougher rules governing when shareholders must be given a vote on stock option plans. In addition, the Council states that the NYSE should reconsider its "broker may vote" policies. The Council recommends that no stock-based compensation plan should be eligible for broker votes. As an alternative, the Council recommends a 5% "total dilution" approach that takes into consideration proposed new shares, shares available for award and outstanding awards for evaluating all proposals and determining whether a broker may vote for its customer.

ACTIONS COMPANIES CAN TAKE NOW

For NYSE-listed companies

- Review current executive compensation and stock option approval practices. If your company does not presently have a compensation committee (most companies do because of the present requirements of Exchange Act Rule 16(b)(3)), consider steps required to establish one.

- If your company has a compensation committee, review its charter. Consider particularly the guidelines for interface between the committee and the chief executive officer. If you do not presently have such a charter or guidelines for such a committee, consider the appropriate content for both the charter and the guidelines. It will be important to have the charter and guidelines meet the parameters of the NYSE Listing Committee proposals if they are adopted.

- If you have existing guidelines regarding approval of executive compensation and equity-based compensation plans, review them in light of the proposed changes as well as your own company's operations and those of its industry. If your board does not have a set of such guidelines (which are different from the guidelines regarding the practices of the compensation committee), consider those which would be appropriate for your company.

For Nasdaq-listed companies

- We recommend a review of the proposed changes to the listing requirements for NYSE companies. The listing requirements of NYSE and Nasdaq tend to resemble each other, and changes made to one are often incorporated fairly shortly thereafter in the other. In addition, we expect in the current environment that Nasdaq's proposed changes announced July 25, 2002 will, when finally proposed and submitted to the SEC for approval, reflect many of the features of the NYSE proposal.

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