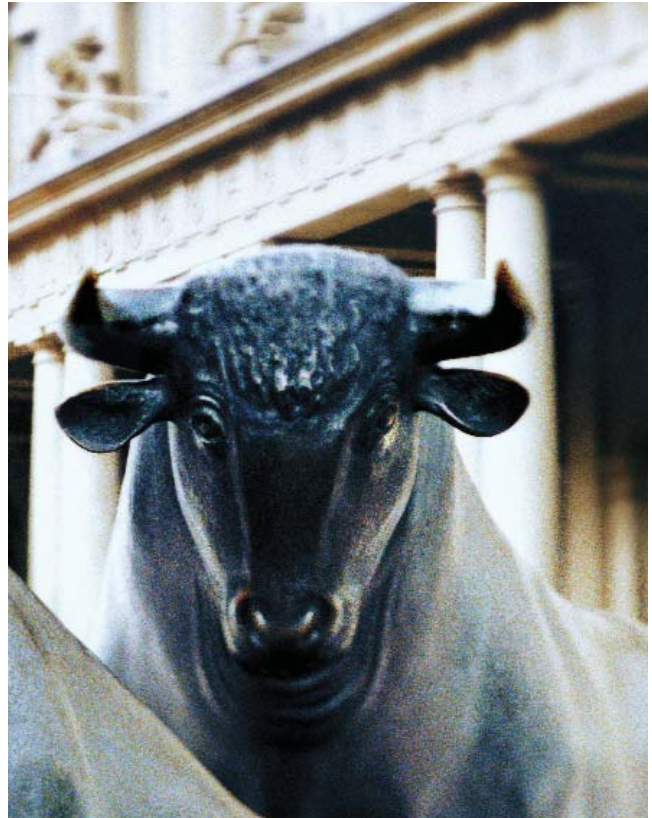


defining issuesTM

JULY 2003 No. 03-15



**NEW LISTING
REQUIREMENTS 1**
THE FASB'S PROJECT 3

New Listing Rules, Accounting Developments for Stock Options

Companies must obtain shareholder approval for most equity-compensation plans, including stock-option plans, according to listing requirements of the New York Stock Exchange and the NASDAQ recently approved by the SEC.¹ The new rules cover material plan changes and repricings, can affect the desirability of different plan arrangements, and come while the FASB moves ahead on accounting for stock options, targeting an exposure draft in the fourth quarter of 2003, with an effective date possibly as early as 2004. This edition of *Defining Issues* describes the major provisions of the new listing requirements and the major developments in the FASB's project on employee stock compensation.

NEW LISTING REQUIREMENTS

The NYSE and NASDAQ require most equity-compensation plans, including material revisions, to be approved or disapproved by shareholders before securities are issued under the plan. The rules' exemptions are limited, unlike prior rules for shareholder approval that generally exempted "broad-based" equity compensation plans that include employees other than officers and directors and de minimis plans.

© 2001, 2002, 2003 KPMG LLP, the U.S.
member firm of KPMG International,
a Swiss nonoperating association.
All rights reserved.

(1) SEC Release No. 34-48108, Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving NYSE and Nasdaq Proposed Rule Changes and Nasdaq Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to NYSE Amendments No. 1 and 2 and Nasdaq Amendments No. 2 and 3 Thereto Relating to Equity Compensation Plans, June 30, 2003, available at www.sec.gov/rules/sro/34-48108.htm.

The NYSE listing rules define equity compensation plans as plans and other arrangements to deliver the company's newly issued equity securities or treasury shares to any employee, director, or other service provider as compensation for services, including a compensatory grant of options or other equity securities that is not made under a plan. This definition includes most equity-compensation plans. The box below presents arrangements that are excluded from the NYSE definition of equity compensation plans and also grants, plans, and amendments that are exempt from shareholder approval. NASDAQ rules address similar plan arrangements.

Grants, plans, and amendments that are exempt from shareholder approval must be approved by the company's compensation committee or a majority of the company's independent directors. The NYSE must be notified in writing when a company uses any of the exemptions.

EXCLUSIONS AND EXEMPTIONS

The exclusions and exemptions below are from the NYSE rules and are included for purposes of illustration. Companies should consult their legal advisors on the exclusions and exemptions applicable to their organizations and specific circumstances.

Arrangements are excluded from the NYSE definition of equity compensation plans if they:

- Will lead to cash payments to employees based on the value of shares, rather than actual shares,
- Are deferred compensation plans under which employees pay full current market value for deferred shares,
- Are made available to shareholders generally (such as a dividend reinvestment plan), or
- Provide a convenient way for employees, directors, or other service providers to purchase stock at fair market value.

The NYSE rules exempt the following plans and forms of compensation from the shareholder approval requirement:

- Inducement awards to persons first becoming an employee of the issuer or any of its subsidiaries;
- Plans acquired in mergers and acquisitions (1) if conversions, replacements, or adjustments of outstanding options or other equity compensation awards are necessary to reflect the transaction or (2) if shares available under certain plans acquired in corporate acquisitions and mergers are used for certain post-transaction grants; and
- Tax qualified, non-discriminatory employee benefit plans (e.g., ESOPs, 401(k) plans) and "parallel excess plans" as defined in the rule.

Under the NYSE rules, material revisions include amendments that expand the scope of the plan. Amendments that curtail the scope of the plan would not otherwise be subject to shareholder approval. The box below provides more detail on material revisions.

Effective Date. The new rules are effective immediately for companies subject to the NYSE and NASDAQ listing requirements. A plan adopted before June 30, 2003 will not be subject to shareholder approval unless and until it is materially revised. Special transition rules apply to formula and discretionary plans. In specified circumstances, the NYSE rules

MATERIAL REVISIONS

The material revisions of equity-compensation plans listed below are from the NYSE rules and are included for purposes of illustration. Companies should consult their legal advisors on the applicability of the relevant material-revision concept to their organizations and specific circumstances.

Under the NYSE rules, a material revision of an equity-compensation plan includes, but is not limited to, the following revisions:

- A material increase in the number of shares available under the plan (other than an increase solely to reflect a reorganization, stock split, merger, spin-off, or similar transaction).
 - Formula Plan - If a plan contains a formula for automatic increases in the shares available 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.
 - Discretionary Plans - 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 its term.
- An expansion of the types of awards available under the plan.
- A material expansion of the class of employees, directors, or other service providers eligible to participate in the plan.
- A material extension of the term of the plan.
- A material change to the method of determining the strike price of options under the plan.
- Repricings - A plan that does not contain a provision that specifically *permits* repricing of options will be considered to *prohibit* repricing. Accordingly, any actual repricing of options will be considered a material revision of a plan even if the plan itself is not revised. Repricing is broadly interpreted to include both direct and indirect repricings, including the cancellation of underwater options in exchange for other options and any other actions that have the same effect. Deleting or limiting any provision prohibiting repricing would also be considered a material revision.

- The modified grant-date approach will be required (i.e., compensation cost would be measured at the grant date and adjusted for actual forfeitures and the outcomes of performance-based awards).
- Compensation cost will be attributed (i.e., expensed) over the service period (generally the vesting period). The service period will be defined as the period during which the employee performs the service in exchange for stock options or similar awards.
- Compensation cost will be recognized ratably over the service period (i.e., not using a units-of-service method, as originally proposed by the IASB).
- Forfeitures will be estimated using the best available estimate of the number of options that are expected to vest, revising that estimate, as necessary, when subsequent information indicates that actual forfeitures are likely to differ from previous estimates. Statement 123 permits this method, but also permits accruing compensation cost as if all instruments granted that are subject only to a service requirement would vest, recognizing forfeitures as they actually occur. The latter method is tentatively prohibited under the current project.
- Adjusting option-pricing models by using the expected life of stock options as an input factor, as required by Statement 123, may not be the most appropriate means to adjust for non-transferability of employee stock options. Such adjustments could be addressed through refining inputs to the models instead of adjusting the models themselves.
- The grant-date valuation of the award should be supported by statistical patterns of employee behaviors as they relate to the timing of exercise of stock options, forfeitures of options upon leaving the company, etc., in various scenarios (e.g., when underlying share price is in-the-money or out-of-the-money). Factoring these patterns into the grant-date valuation would effectively adjust the fair value for lack of transferability and certain vesting criteria.
- Binomial-based option pricing models enable estimation of a number of possible outcomes at different times. These models allow probability-based discounted cash flows to be used in conjunction with patterns of employee behaviors and other patterns in input factors to obtain a more accurate fair value at grant date. Scenario-dependent outcomes (i.e., like multiple branches on a tree model) could also be used to accommodate unique features of employee options into the grant date valuation, including volatility for private companies, options with reload features, and post-vesting restrictions on sale.

The FASB, in consultation with its newly formed Option Valuation Group (OVG), is considering methods to determine fair value, including the use of option-pricing models and inputs to those models. Valuing stock-based awards is controversial, and no decisions, even tentative ones, have been made. However, the following observations were made at a recent meeting of the FASB and its OVG.

- Companies today are likely using the Black-Scholes option pricing model for awards that do not have the characteristics best suited to that model. Members of the OVG suggested that binomial-based models are superior for most employee stock-based awards, including stock options. The Board might consider requiring a model that marketplace participants would use to value the specific award in question.
- Under Statement 123, the volatility input to option pricing models is typically based on historical volatility measures of the underlying stock. The FASB may encourage the use of implied volatility (i.e., the volatility implied in an exchange-traded option) when it is available, in conjunction with historical volatility and also industry-specific implied and historical volatility, to achieve a more balanced volatility factor. The volatility factor may also consider volatility over different time periods for different scenarios through binomial modeling.



These observations and possibilities are likely to receive additional attention in the coming months. The FASB will also be addressing these issues: a measurement model for nonemployee transactions, measurement and attribution for cash-settled and multiple-settlement features of stock-based compensation, accounting for modifications and settlements, and whether all or some portion of the income tax effects of stock options should be recognized in earnings.

The FASB plans to issue an exposure draft in the fourth quarter of 2003 that could become effective in 2004. Until a new Statement is issued, the provisions of Statement 123 remain in effect.

Companies should not treat the descriptive and summary statements in this presentation as a substitute for the text of the SEC, NYSE, or NASDAQ rules. Nor should companies treat the statements about potential accounting requirements in this presentation as if they are what the FASB will finally adopt. The FASB and IASB projects described above have not yet resulted in standards, and the related issues are still under consideration. Companies should refer to the text of the SEC, NYSE, and NASDAQ rules, and to the final FASB Statement when it is completed and published. In complying with requirements, companies should consult their accounting and legal advisors.

This is a publication of
KPMG's Department of
Professional Practice.

The phone number is
(212) 909-5600

Contributing authors:

John R. Deming

Julia F. Cullen

Kimberly J. Miousse

Copies are available at:

www.kpmg.com