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Corporate & Securities

September 19, 2016

# New FAQs Clarify Shareholder Approval Rules For Stock-For-Tax Withholding

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*It has been close to a decade since the New York Stock Exchange (NYSE) last updated its set of frequently asked questions (FAQs) regarding equity compensation plans. On August 18, 2016, the NYSE released updated FAQs and, although the update primarily clarifies certain FAQs and eliminates certain stale FAQs, it does significantly revise an FAQ relating to shareholder approval of share recycling provisions in equity compensation plans. In particular, the updated FAQ permits NYSE-listed companies to amend their equity compensation plans without shareholder approval to reflect the new accounting rules relating to stock-for-tax withholding.*

## Share Withholding for Tax Obligations

Earlier this year, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-09 intended to simplify accounting for stock-based compensation under FASB Accounting Standards Codification Topic 718 (Topic 718). Both Topic 718 and ASU 2016-09 apply to public and private companies.[1]

Under Topic 718, stock-based compensation may be classified as either equity or liabilities. If an award is classified as equity, the fair value of the award is measured on the grant date of the award and the compensation cost is amortized over the life of the award. If an award is classified as a liability, however, the fair value of the award must be re-measured at each reporting date until the award is settled, with any changes in the fair value recognized as a compensation cost. A company will generally seek to avoid liability accounting classification as it can result in greater costs to the company's earnings.

Prior to ASU 2016-09, Topic 718 provided that, if a company withheld shares to satisfy a grantee's tax obligations for equity awards at a rate in excess of such grantee's minimum statutory withholding tax rate,

[1] For public companies, ASU 2016-09 is effective for annual reporting periods beginning after December 15, 2016 and interim periods within those annual periods. For private companies, ASU 2016-09 is effective for annual reporting periods beginning after December 15, 2017 and interim periods within annual periods beginning after December 15, 2018.

then the entire equity award would be classified as a liability. ASU 2016-09 amended Topic 718 to eliminate this rule and permit companies to withhold shares to satisfy a grantee's tax obligations for equity awards up to such grantee's maximum statutory tax rate for each applicable jurisdiction without adverse tax consequences. The maximum statutory rate is based on federal, state and local taxes and is determined on a jurisdiction-by-jurisdiction basis.

As many companies have the minimum statutory withholding tax requirement baked into their equity compensation plans, this change in accounting standards raises the question of whether companies should amend their plans to reflect this change and, if so, whether for public companies such an amendment would require shareholder approval under the company's applicable listing rules.

## NYSE Shareholder Approval Rules

Rule 303A.08 of the NYSE Listed Company Manual (Rule 303A.08) generally provides that shareholders of a listed company must be given the opportunity to vote on all equity compensation plans and material revisions to such plans.

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. An equity compensation plan also includes a compensatory grant of stock options or other equity securities that is issued under a plan.

Rule 303A.08 sets forth a non-exhaustive list of material revisions to equity compensation plans that require shareholder approval. Included within the list is an example relating to equity compensation plans that contain a formula for automatic increases in the shares available for issuance under the plans (also referred to as an "evergreen formula") or for automatic grants of equity awards pursuant to a formula (i.e., so-called formula plans). Under Rule 303A.08, unless the formula plan has a term of not more than 10 years, each such increase or grant is a material revision to the plan requiring shareholder approval.

In determining whether an equity compensation plan is a formula plan, the plan's share recycling provisions – provisions that specify the circumstances under which shares may be added back to the share pool (e.g., shares withheld or surrendered to satisfy tax obligations) – must be considered. The NYSE FAQs provide guidance in this regard.

## Revised NYSE FAQs for Formula Plans

Prior to the update, the NYSE FAQs provided that a provision in an equity compensation plan to add back shares to a share pool (a share recycling provision) would not be a formula so long as such shares were never in fact issued to the grantee.

While this concept remains unchanged in the update to the NYSE FAQs, in response to ASU 2016-09, the updated FAQs provide that an amendment to an equity compensation plan to permit withholding of shares based on a grantee's maximum tax obligation (rather than the statutory minimum tax rate) is not a material revision requiring shareholder approval. However, this is only the case if the withheld shares are never issued to the grantee, even if the withheld shares are added back to the share pool under the equity compensation plan.

The updated NYSE FAQs also revise the following examples of share recycling for purposes of the formula plan rules:

| | Pre-NYSE FAQ Update | Post-NYSE FAQ Update |
|---|---|---|
| **Vesting of Shares of Restricted Stock** | Adding back shares that are withheld from restricted stock on vesting to cover taxes is a formula. | Adding back shares that are withheld from restricted stock on vesting to cover taxes is a formula, **unless the forfeited shares are immediately cancelled.** |
| **Tendered / Repurchased Shares** | Adding back shares that an optionee already owns that are tendered to pay the exercise price of an option or that are repurchased by the company using the cash paid upon the exercise of an option is a formula. | Adding back shares that a **grantee** already owns that are tendered to pay the exercise price of an option **or satisfy a tax obligation** or that are repurchased by the company using the cash paid upon the exercise of an option is a formula. |
| **Payment of Exercise Price / Tax Withholding** | Adding back shares that are held back upon exercise of an option or settlement of an award to cover the exercise price or tax withholding is not a formula. | Adding back shares that are held back (a) upon exercise of an option ~~or settlement of an award~~ to cover the exercise price of an option ~~or tax withholding~~ **or (b) satisfy income tax obligations** is not a formula. |

The updated NYSE FAQs did not change the following examples of share recycling: (1) adding back shares of restricted stock that are forfeited rather than vesting is not a formula (even though, as a technical matter, the shares of restricted stock are issued on grant) and (2) adding back shares that are subject to an option that expires without being exercised or another award that is forfeited without the shares having been issued is not a formula. Restricted stock units that are forfeited would be covered by the second example.

## NASDAQ Shareholder Approval Rules

Under NASDAQ Listing Rule 5635(c) (Rule 5635(c)), subject to certain limited exceptions, approval by shareholders of a listed company is required when a stock option or purchase plan is established or amended or other equity compensation arrangement is made or materially amended.

Like NYSE Rule 303A.08, Rule 5635(c) specifically addresses shareholder approval of formula plans. However, unlike NYSE Rule 303A.08, Rule 5635(c) provides that a formula plan cannot have a term in excess of 10 years unless shareholder approval is obtained every 10 years. In other words, formulaic increases in shares under an equity compensation plan do not require shareholder approval if the term of the plan does not exceed 10 years.

Further, a NASDAQ staff interpretation provides that an amendment to an equity compensation plan to permit withholding of taxes would not be a material amendment to the plan requiring shareholder approval.

Although this interpretative guidance is helpful, NASDAQ has not yet issued guidance on whether an amendment to permit withholding at the maximum tax rate requires shareholder approval. For this reason, it would be advisable for NASDAQ-listed companies to discuss the issue with their listing agent at NASDAQ or obtain shareholder approval of an amendment to an equity compensation plan to permit withholding of shares based on a grantee's maximum tax rate if such withheld shares were once again available for issuance to participants as equity-based awards under the plan (i.e., if such withheld shares were "recyclable" under the plan).

## Practical Considerations

Public and private companies should review their equity compensation plans and award agreements to determine whether to amend them to conform with ASU 2016-09. This may be an easier decision for companies listed on the NYSE as the updated FAQs expressly provide that shareholder approval is not required for such an amendment. For NASDAQ-listed companies, on the other hand, this may be a more complicated decision as the lack of NASDAQ guidance suggests that shareholder approval would be required for such an amendment if the withheld shares were available for re-grant to participants under the plan. In determining whether to amend their equity compensation plans to permit withholding of shares up to a grantee's maximum statutory tax rate, companies should consider the impact of such an amendment on their cash flow.

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If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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