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Capital Markets and Securities

A bulletin prepared by the Capital Markets Group at Vedder Price designed to keep corporate executives and investment banking professionals informed of major developments in the securities industry.

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SEC ADOPTS REVISED RULES REQUIRING SHAREHOLDER APPROVAL OF EQUITY-COMPENSATION PLANS

On June 30, 2003, the Securities and Exchange Commission ("SEC") adopted, on an accelerated basis, revised rules issued by the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers, Inc. ("NASD") through its subsidiary The Nasdaq Stock Market, Inc. ("Nasdaq"), relating to shareholder approval of equity (also known as "stock-based") compensation plans. These rules are — for the most part — effective immediately (but see the "Effective Date and Transition Rules" section below for special rules). NYSE- and Nasdaq-listed companies will need to examine these revised rules to:

1. see whether their equity compensation programs fit squarely within the new requirements without modifications,
2. be aware of the effective dates and transition rules,
3. understand the new approval and disclosure requirements relating to plans exempt from shareholder approval, and
4. make sure that the rules will not negatively impact their future equity-compensation planning.

BACKGROUND

Shareholder approval of equity-compensation plans has been required by the NYSE and Nasdaq — as well as under federal and state statutes and regulations — for years. Under old NYSE Rule 312.03, shareholder approval was a prerequisite to listing when:

> a stock option or purchase plan is to be established or other arrangements made pursuant to which stock may be acquired by officers and directors, except for warrants or rights issued generally to security holders of the company or broadly-based plans or arrangements including other employees (*e.g.*, ESOPS). . . where shares are issued to a person not previously employed by the company, as an inducement essential to his entering into an employment contract with the company, shareholder approval may not be required.

Nasdaq had a similar rule. Of course, no one was sure what a broadly based plan was, but as discussed in the next paragraph, most equity-compensation plans involving officers and directors were required to be approved by shareholders by other rules. However, in the latter 1990s, due to perceived abuses by companies that loosely construed the term "broadly based plans" and that took the position that certain equity-compensation plans did not require shareholder approval under the existing rules, the NYSE, with SEC backing, began what was called a "pilot" program that sought to define and narrow the term "broadly based." This pilot program was renewed several times and was in effect up until the finalization of these revised rules.

In addition to the NYSE and Nasdaq listing rules, other rules required shareholder approval of certain equity-compensation plans. Up until 1996, Rule 16b-3 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") required that equity-compensation plans be approved by shareholders in order for a compensatory award granted under an equity-compensation plan to qualify for exemption from the insider trading rules of Section 16(b) of the Exchange Act. Under the Internal Revenue Code ("IRC"), tax-qualified "statutory" or "incentive" stock options (including arrangements involving certain employee stock purchase plans) required shareholder approval in order for compensation attributable to increases in the stock price to be treated as long-term capital gain and not ordinary income. Since 1993, shareholder approval of equity-compensation plans has generally been a prerequisite for the tax deductibility of stock-based compensation paid to the five highest-paid executives of a public company. Finally, a few states (*e.g.*, New York, Alaska, Hawaii, New Mexico, Maine, Vermont and West Virginia) did (or still do) require shareholder approval of stock option plans.

However, all this changed following the fallout caused by the corporate scandals of 2001-2002. By October 2002, the NYSE and Nasdaq had each released proposed rules relating to corporate governance that included revised rules for shareholder approval of equity-compensation plans. At the request of the SEC, the NYSE and Nasdaq "spun out" the shareholder-approval rules from the rest of the corporate-governance rules, and published the proposed shareholder-approval rules in the Federal Register on October 11, 2002 and October 17, 2002, respectively. Many believed these rules would be effective during the 2003 proxy season. However, the proposed rules were not finalized until after the 2003 proxy season when, on June 30, 2003, the SEC issued Release 34-48108 .

The discussion below pertains to the revised rules as finalized and approved by the SEC; it does not discuss changes between the final revised rules and the proposed revised rules previously released by NYSE and Nasdaq. In addition, the revised rules generally apply to U.S. listed companies; non-U.S. companies that list their securities on the NYSE or Nasdaq will most likely need to follow the rules relating to certification that the issuers are in compliance with their home country practices regarding corporate governance, and will be required to disclose how their home country practices differ.

THE REVISED RULES

General Rule

The NYSE rule simply states that "all equity-compensation plans, and any material revisions to the terms of such plans, [are] subject to shareholder approval, with [some] limited exemptions. . ." Recognizing the problems associated in the past with excluding broadly based plans, the term "equity-compensation plan" is now defined as "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." Thus, even a compensatory grant of options or other equity securities that is not made under a formal plan is, nonetheless, a grant under an "equity-compensation plan."

The NYSE rule states that the following plans are not "equity-compensation plans," even if the brokerage and other costs of the plan are paid for by the listed company:

- plans that are made available to shareholders generally, such as a typical dividend reinvestment plan; and
- plans that merely allow employees, directors or other service providers to elect to buy shares on the open market or from the listed company for their current fair market value, regardless of whether (i) the shares are delivered immediately or on a deferred basis, or (ii) the payments for the shares are made directly or by giving up compensation that is otherwise due (for example, through payroll deductions).

Similarly, the Nasdaq rule simply requires shareholder approval "prior to the issuance of designated securities when a stock option or purchase plan is to be established or materially amended or other equity compensation arrangement made or materially amended pursuant to which options or stock may be acquired by officers, directors, employees, or consultants. . .” Nasdaq does not define the term “equity compensation arrangement,” and thus it does not specify arrangements that fall outside the category of “equity compensation arrangements.” However, both the NYSE and Nasdaq rules create a list of exemptions from the general rule, of which Nasdaq includes plans that otherwise would not meet the definition of “equity-compensation plan” under the NYSE rules.

General Exemptions

The exemptions under both the NYSE and the Nasdaq rules generally fall into the following three categories:

- new hire inducement awards;
- awards relating to merger and acquisitions; and
- awards relating to certain tax-qualified or non-qualified pension plans.

NYSE Exemptions

Requirement of Board or Committee Approval: The NYSE rule does not require shareholder approval of employment inducement awards, certain grants, plans and amendments in the context of mergers and acquisitions, and certain specific types of plans. However, these exempt grants, plans and amendments may be made only with the approval of the company’s independent compensation committee or the approval of a majority of the company’s independent directors. Companies must also notify the NYSE in writing when they use one of these exemptions.

Employment Inducement Awards: An employment inducement award is a grant of options or other equity-based compensation as a material inducement to a person or persons being hired by the listed company or any of its subsidiaries, or being rehired following a bona fide period of interruption of employment. Inducement awards include grants to new employees in connection with a merger or acquisition. Promptly following a grant of any inducement award in reliance on this exemption, the listed company must disclose in a press release the material terms of the award, including the recipient of the award and the number of shares involved.

Mergers and Acquisitions: Two exemptions apply in the context of corporate acquisitions and mergers. First, shareholder approval will not be required to convert, replace or adjust outstanding options or other equity-compensation awards to reflect the transaction. Second, shares available under certain plans acquired in corporate acquisitions and mergers may be used for certain post-transaction grants without further shareholder approval. This exemption applies to situations where a party that is not a listed company following the transaction has shares available for grant under pre-existing plans that were previously approved by shareholders. A plan adopted in contemplation of the merger or acquisition transaction would not be considered “pre-existing” for purposes of this exemption. Shares available under such a pre-existing plan may be used for post-transaction grants of options and other awards with respect to equity of the entity that is the listed company after the transaction, either under the pre-existing plan or another plan, without further shareholder approval, so long as:

- the number of shares available for grants is appropriately adjusted to reflect the transaction;
- the time during which those shares are available is not extended beyond the period when they would have been available under the pre-existing plan, absent the transaction; and
- the options and other awards are not granted to individuals who were employed, immediately before the transaction, by the

post-transaction listed company or entities that were its subsidiaries immediately before the transaction.

Any shares reserved for listing in connection with a transaction pursuant to either of these exemptions would be counted by the NYSE in determining whether the transaction involves the issuance of 20% or more of the company's outstanding common stock and thus would otherwise require shareholder approval under NYSE's Listed Company Manual Section 312.03(c).

The NYSE believes that these merger-related exemptions will not result in any increase in the aggregate potential dilution of the combined enterprise. Moreover, the NYSE believes that mergers or acquisitions are not routine occurrences, and thus are not likely to be abused. Accordingly, the NYSE considers both of these exemptions to be consistent with the fundamental policy involved in this standard.

Tax-Qualified/Non-Qualified Plans: The NYSE has exempted three types of tax-qualified or non-qualified pension plans from the rules:

- plans intended to meet the requirements of IRC Section 401(a) ("401(a) Plans");
- plans intended to meet the requirements of IRC Section 423 ("423 Plans"); and
- "parallel excess plans."

A "parallel excess plan" is defined by the NYSE as a "pension plan" within the meaning of the Employee Retirement Income Security Act of 1974 that is designed to work in parallel with a plan intended to be qualified under IRC Section 401(a) to provide benefits that exceed the limits set forth in IRC Section 402(g) (the section that limits an employee's annual pre-tax contributions to a 401(k) plan), IRC Section 401(a)(17) (the section that limits the amount of an employee's compensation that can be taken into account for plan purposes) and/or IRC Section 415 (the section that limits the contributions and benefits under qualified plans) and/or any successor or similar limitations enacted after the adoption of the revised rules. However, a plan will not be considered a parallel excess plan unless:

- it covers all or substantially all employees of an employer who are participants in the related qualified plan whose annual compensation is in excess of the limit imposed by IRC Section 401(a)(17) (or any successor statute or similar statute enacted after the adoption of this rule that imposes similar limitations);
- its terms are substantially the same as the qualified plan that it parallels, except for the elimination of the IRC Section 401(a)(17) limits and the limitation described in the below bullet; and
- no participant receives employer equity contributions under the plan in excess of 25% of the participant's cash compensation.

The 401(a) Plans and 423 Plans are exempt, according to the NYSE, because they are already regulated under the IRC and Treasury regulations. The 423 Plans, which are stock purchase plans under which an employee can purchase no more than $25,000 worth of stock per year at a plan-specified discount capped at 15%, are also required by the IRC to receive shareholder approval. While 401(a) Plans and parallel excess plans are not required to be approved by shareholders, U.S. GAAP requires that the shares issued under these plans be treated as a compensation expense on the income statement by the company issuing the shares.

An equity-compensation plan that provides non-U.S. employees with substantially the same benefits as a comparable 401(a) Plan, 423 Plan or parallel excess plan that the listed company provides to its U.S. employees, but for features necessary to comply with applicable foreign tax law, are also exempt from shareholder approval.

Nasdaq Exemptions

The Nasdaq rule exempts the following:

- warrants or rights issued generally to all security holders of the company or stock purchase plans available on equal terms to all security holders of the company (such as a dividend reinvestment plan);

- tax qualified, nondiscriminatory employee benefit plans (*e.g.*, plans that meet the requirements of IRC Sections 401(a) or 423);

- "parallel nonqualified plans," provided such plans are approved by the issuer's compensation committee or a majority of the issuer's independent directors;

- plans that merely provide a convenient way to purchase shares on the open market or from the issuer at fair market value;

- plans or arrangements relating to an acquisition or merger, as permitted under NASD Rule IM-4350-5; and

- issuances to a person not previously an employee or director of the company, or following a bona fide period of non-employment, as an inducement material to the individual's entering into employment with the company, provided such issuances are approved by either the issuer's compensation committee comprised of a majority of independent directors or a majority of the issuer's independent directors.

The definition of a 'parallel nonqualified plan" under the Nasdaq rule is the same as the definition of a "parallel excess plan" under the NYSE rule.

Similar to the NYSE rule, the Nasdaq rule requires that inducement grants, tax qualified non-discriminatory benefit plans, and parallel nonqualified plans are subject to approval by either the issuer's compensation committee comprised of a majority of independent directors, or a majority of the issuer's independent directors; however, Nasdaq does not require the written notification or press release as under the NYSE rule. Nasdaq does state that a company would not be permitted to use repurchased shares to fund option plans or grants without prior shareholder approval.

Finally, with respect to plans or arrangements involving a merger or acquisition, shareholder approval is not required in two situations. First, shareholder approval will not be required to convert, replace or adjust outstanding options or other equity compensation awards to reflect the transaction. Second, shares available under certain plans acquired in acquisitions and mergers may be used for certain post-transaction grants without further shareholder approval. This exception applies to situations where the party that is not a listed company following the transaction has shares available for grant under pre-existing plans that meet the requirements of this revised rule. These shares may be used for post-transaction grants of options and other equity awards by the listed company (after appropriate adjustment of the number of shares to reflect the transaction), either under the pre-existing plan or arrangement or another plan or arrangement, without further shareholder approval, provided:

- the time during which those shares are available for grants is not extended beyond the period when they would have been available under the pre-existing plan, absent the transaction; and

- such options and other awards are not granted to individuals who were employed by the granting company or its subsidiaries at the time the merger or acquisition was consummated.

Nasdaq would view a plan or arrangement adopted in contemplation of the merger or acquisition transaction as not pre-existing for purposes of this exception. Nasdaq considers this exception to be appropriate because it will not result in any increase in the aggregate potential dilution of the combined enterprise. However, any additional shares available for issuance under a plan or arrangement acquired in a connection with a merger or acquisition would be counted by Nasdaq in determining whether the transaction involved the issuance of 20% or more of the company's outstanding common stock, thus triggering the shareholder approval requirements under NASD Rule 4350(i)(1)(C).

Formula and Discretionary Plans

Under both the NYSE and Nasdaq rules, care must be taken with respect to formula and discretionary plans. A formula plan is a plan that contains a formula for automatic increases in the shares available (sometimes called an "evergreen formula") or for automatic grants pursuant to a formula. Examples of automatic grants pursuant to a formula are:

- annual grants to directors of restricted stock having a certain dollar value; and
- "matching contributions," whereby stock is credited to a participant's account based upon the amount of compensation the participant elects to defer.

A "discretionary plan" is a plan that is not a formula plan and which contains no limit on the number of shares available to be granted under such plan. A requirement in a plan that grants be made out of treasury shares or repurchased shares will not, in itself, be considered a limit or pre-established formula so as to prevent a plan from being considered a discretionary plan.

The importance of these types of plans is explained in the section below discussing material revisions and material amendments.

Material Revisions/Material Amendments

Shareholder approval is not only required when an equity-compensation plan is first established by a listed company, but also when an existing, already approved plan is materially modified. For this purpose, the NYSE rule uses the term "material revision," while the Nasdaq rule uses the term "material amendment."

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

- a material increase in the number of shares available under the plan (other than an increase solely to reflect a reorganization, stock split, merger, spinoff or similar transaction);
- 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; and
- the deletion or limitation of any provision prohibiting repricing of options.

If the plan is a formula plan, then each increase or grant under the formula will be considered a material revision requiring shareholder approval, unless the plan has a term of not more than 10 years. If a plan is a discretionary plan, then each grant under the plan will require separate shareholder approval, regardless of whether the plan has a term of not more than 10 years.

The NYSE rule states that an amendment will not be considered a "material revision" if it curtails rather than expands the scope of the plan in question. In addition, a change in the method of determining "fair market value" from the closing price on the date of grant to the average of the high and low price on the date of grant is an example of a change that the NYSE would not view as material.

Under the Nasdaq rule, a material amendment includes (but is not limited to) the following:

- any material increase in the number of shares to be issued under the plan (other than to reflect a reorganization, stock split, merger, spinoff or similar transaction);
- any material increase in benefits to participants, including any material change to: (i) permit a repricing (or decrease in exercise price) of outstanding options, (ii) reduce the price at which shares or options to purchase shares may be offered, or (iii) extend the duration of a plan;
- any material expansion of the class of participants eligible to participate in the plan; and
- any expansion in the types of options or awards provided under the plan.

The Nasdaq rule recognizes that, while general authority to amend a plan would not obviate the need for shareholder approval, if a plan permits a specific action without further shareholder approval, then no such approval would generally be required. However, formula plans cannot have a term in excess of 10 years unless shareholder approval is obtained every 10 years. In addition, discretionary plans require shareholder approval of each grant under the plan. As mentioned above, requiring that grants be made out of treasury shares or repurchased shares will not alleviate these additional shareholder-approval requirements, since such a plan could still be treated as a discretionary plan.

Repricings

The repricing of stock options (*i.e.*, when the company lowers the exercise price of an outstanding stock option, usually because the stock price has dropped precipitously) has always been controversial since it creates a disconnect between management and shareholders. It became a very hot corporate-governance issue ever since the Financial Accounting Standards Board decided to levy variable-award accounting on repriced stock options in December 1998. Coupled with the stock market bubble burst in the first quarter of 2000, and the market's high volatility during 2001 and 2002, the controversy has never subsided. Accordingly, to address these corporate-governance concerns, the new rules impose substantial restrictions on repricings without shareholder approval.

Under the NYSE rules, a plan that does not contain a provision that specifically permits repricing of options will be considered for purposes of this listing standard as prohibiting repricing. Accordingly, any actual repricing of options will be considered a material revision of a plan, even if the plan itself is not revised. This consideration will not apply to a repricing through an exchange offer that commenced before the date this listing standard became effective. The NYSE rule defines "repricing" as any of the following, or any other action that has the same effect:

- lowering the strike price of an option after it is granted;
- any other action that is treated as a repricing under generally accepted accounting principles; or
- canceling an option at a time when its strike price exceeds the fair market value of the underlying stock, in exchange for another option, restricted stock, or other equity, unless the cancellation and exchange occurs in connection with a merger, acquisition, spin-off or other similar corporate transaction.

It is noted that the Nasdaq rule is silent with respect to whether a plan without an explicit repricing provision prohibits repricing.

Broker Votes

The NYSE rule precludes NYSE member organizations from giving a proxy to vote on equity-compensation plans unless the beneficial owner of the shares has given voting instructions. Thus, brokers cannot vote shares held in "street name" unless the vote is authorized by the actual shareholder. The NYSE has stated that it will establish a working group to advise with respect to the need for, and design of, mechanisms to facilitate implementation of the proposal that brokers may not vote on equity-compensation plans presented to shareholders without instructions from the beneficial owners, and that this will not delay the effectiveness of the broker-may-not-vote proposal.

The Nasdaq rule does not address the broker-vote issue, since NASD rules currently prohibit discretionary voting by brokers without explicit instructions from the beneficial owner.

General Effective Dates and Transition Rules

The NYSE and Nasdaq revised rules became effective June 30, 2003. Except as provided below, an equity-compensation plan or arrangement that was adopted before this date will not be subject to shareholder approval unless and until it is materially revised or amended.

NYSE-Specific Effective Dates and Transition Rules

Under the NYSE rule, in the case of a discretionary plan, whether or not previously approved by shareholders, additional grants may be made after June 30, 2003 without further shareholder approval only for a limited transition period, and then only in a manner consistent with past practice. In applying this rule, if a plan can be separated into a discretionary plan portion and a portion that is not discretionary, the non-discretionary portion of the plan can continue to be used separately, under the appropriate transition rule. For example, if a shareholder-approved plan permits both grants pursuant to a provision making available a specific number of shares, and grants pursuant to a provision authorizing the use of treasury shares without regard to the specific share limit, the former provision (but not the latter) may continue to be used after the transition period, under the general rule above.

Similarly, in the case of a formula plan that either has not previously been approved by shareholders or does not have a term of 10 years or less, additional grants may be made after June 30, 2003 without further shareholder approval only for a limited transition period.

The limited transition period described in the preceding two paragraphs will end upon the first to occur of:

- the listed company's next annual meeting at which directors are elected that occurs more than 180 days after June 30, 2003 (*i.e.*, December 27, 2003);
- June 30, 2004; and
- the expiration of the plan.

A shareholder-approved formula plan may continue to be used after the end of this transition period if it is amended to provide for a term of 10 years or less from the date of its original adoption or, if later, the date of its most recent shareholder approval. Such an amendment may be made before or after June 30, 2003, and would not itself be considered a "material revision" requiring shareholder approval. In addition, a formula plan may continue to be used, without shareholder approval, if the grants after June 30, 2003 are made only from the shares available immediately before June 30, 2003 (in other words, based on formulaic increases that occurred prior to June 30, 2003).

Finally, the rule proscribing broker voting on shares held in "street name" becomes effective 90 days after June 30, 2003 — or September 28, 2003.

CONCLUSION

The revised NYSE and Nasdaq rules requiring shareholder approval of essentially all equity-compensation plans were promulgated to protect the interests of shareholders from dilution and abuses relating to excessive or inappropriate compensation. With these rules now in effect, companies that have reviewed their equity-compensation plans and have taken action with respect to such plans prior to June 30, 2003 will need to assess whether there is a likelihood of materially modifying their plans in the future. Companies that had taken a wait-and-see approach, or that now need to establish new plans or modify existing plans, will need to make sure that the new or modified plans are compliant with the revised rules (*e.g.*, explicit repricing provisions). In addition, all companies will need to be mindful of the board/committee approval requirements for plans that qualify for exemption from the shareholder-approval requirements, as well as written notification and possible disclosure requirements for exempt plans and grants.

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Editor: Steven J. Gray

VEDDER, PRICE, KAUFMAN & KAMMHOLZ, P.C.

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Principal Members of the Capital Markets Group:

Steven R. Berger *(New York)*	212/407-7714
John T. Blatchford	312/609-7605
Thomas P. Desmond	312/609-7647
Jennifer R. Evans	312/609-7686
Robyn B. Goldman	312/609-7662
Steven J. Gray *(Chair)*	312/609-7528
Jennifer Durham King	312/609-7835
James W. Morrissey	312/609-7717
Meeghan O'Donnell	312/609-7529
Jason K. Zachary	312/609-7757

Participating Members of the Capital Markets Group:

James A. Arpaia	312/609-7618
William J. Bettman	312/609-7776
Deborah B. Eades	312/609-7661
Karin Jagel Flynn	312/609-7805
Dean N. Gerber	312/609-7638
Dan L. Goldwasser *(New York)*	212/407-7710
Douglas M. Hambleton	312/609-7684
John T. McEnroe	312/609-7885
Daniel C. McKay II	312/609-7762
Maureen A. Miller	312/609-7699
Robert J. Moran	312/609-7517
Michael A. Nemeroff	312/609-7858
John R. Obiala	312/609-7522
Cathy G. O'Kelly	312/609-7657
Daniel O'Rourke	312/609-7669
Stewart Reifler (*New York*)	212/407-7742
Ronald Scheinberg *(New York)*	212/407-7730
Guy E. Snyder	312/609-7656
Robert J. Stucker	312/609-7606
David A. Sturms	312/609-7589
Dalius F. Vasys	312/609-7623
Donald A. Wassall *(New York)*	212/407-7707
Richard L. Williams III	312/609-7588

Chicago
222 North LaSalle Street
Chicago, Illinois 60601
312/609-7500
Fax: 312/609-5005

New York
805 Third Avenue
New York, New York 10022
212/407-7700
Fax: 212/407-7799

New Jersey
354 Eisenhower Parkway, Plaza II
Livingston, New Jersey 07039
973/597-1100
Fax: 973/597-9607

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