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New York • Chicago • Los Angeles

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TRANSFERABLE STOCK OPTIONS: MICROSOFT'S PROGRAM

Microsoft and JPMorgan Chase Bank have developed an innovative program that provides employees with an opportunity to realize value from stock options that are out-of-the-money. The Stock Option Transfer Program offers companies an alternative to traditional out-of-the-money option exchange programs; however, employee proceeds are discounted and there are substantial transaction costs to the company associated with the Program.

Background

On July 8, 2003, Microsoft made several announcements regarding its equity compensation program, including:

- Beginning in Fiscal 2004, employees will receive grants of performance stock and/or restricted stock unit awards (without dividend equivalents) in lieu of stock option grants[1]

- The Company will account for equity compensation under Financial Accounting Standard 123 (FAS 123), and will voluntarily restate earnings to reflect costs associated with prior years' stock option grants

- Employees holding underwater stock options will have a one-time opportunity to transfer their options to JPMorgan Chase & Co. (JPMorgan) in exchange for cash

On October 15, 2003, Microsoft filed a registration statement and tender offer to effectuate the Stock Option Transfer Program.

Program Overview

The Stock Option Transfer Program will operate as follows:

- Microsoft employees will have a one-time opportunity to voluntarily elect to tender all of their vested and unvested options with exercise prices above $33 to Microsoft, at which time the options will be canceled

    — Approximately 37,000 employees in 73 countries are eligible to participate

[1] Refer to our letter "A Retreat from Options: Microsoft's New Stock Compensation Program" dated July 28, 2003 for a more detailed description of the new equity compensation program http://www.fwcook.com/alert_letters/7-28-03 Microsoft.pdf

- Could cover a total of 624 million options with a notional value of $18 billion

- Microsoft will grant new options to JPMorgan equal to the number of shares tendered to Microsoft by its employees

  - The new options will retain the original exercise prices; however, the option term will be reduced to 24 to 36 months

- In consideration for the tendered options, JPMorgan will make a cash payment to Microsoft equal to the "present value" of the transferred options, as determined using the binomial option pricing model

  - "Present value" includes time value, i.e., the value attributable to the remaining option term, as well as intrinsic value, i.e., the spread, if any

  - Time value of transferred options will be lower after transfer due to the reduction in the option term <u>and</u> lower assumed future volatility

    - Future volatility is expected to be lower as a result of JP Morgan's hedging activities (i.e., as stock price rises, JP Morgan will sell shares to maintain its hedged position (and vice versa), which will have the effect of dampening MSFT's volatility)

- Microsoft will make an initial cash payment to participants by December 31, 2003, and remaining payments will be made over a two to three year period (depending upon the level of employee), subject to continued employment

The <u>Attachment</u> to this letter provides greater detail on the terms of the Microsoft Stock Option Transfer Program.

Advantages

The advantages of the Stock Option Transfer Program are as follow:

- Given the voluntary nature of the Program, likely improves employee morale and enhances employee retention by providing employees with the opportunity to realize value from their underwater stock options

  - While there may not be any intrinsic value, there is value attributable to the remaining option term

- Reduces future overhang and potential dilution from outstanding stock options

  - Overhang will decrease in the future due to the truncation of the option terms (i.e., options will either be exercised by JPMorgan or expire within 36 months following the transaction)

- EPS dilution under the treasury stock method may be reduced since options will have less time to have a large intrinsic gain

- Results in no additional compensation expense under FAS 123
    - However, Microsoft will incur a charge to earnings equal to the unrecognized compensation cost associated with unvested options

- Total proceeds from the transfer to JPMorgan when paid to participants are tax deductible by Microsoft[2] (and taxable to participants upon receipt)
    - At 100% participation and a $27 stock price, total proceeds would be $919 million[3], resulting in a $303 million tax deduction based on Microsoft's effective tax rate of 33%
    - Payments will not qualify as performance-based under IRC §162(m) and would therefore not be tax deductible if currently paid to a named executive officer

- Microsoft will have positive cash flow equal to the tax deduction on the transferred options
    - Payments funded entirely out of cash consideration provided to Microsoft from JPMorgan

- Results in share issuance only to the extent that options are exercised during the truncated term

Disadvantages

There are several disadvantages to this Program, including:

- Proceeds from transfer will reflect a discount to the pre-transfer option present value
    - Reduction in option term and lower future volatility expectations reduce the present value of the transferred options
    - The sale of MSFT shares by JPMorgan to put JPMorgan in its desired hedge position may also have the effect of reducing the cash-out value to participants since the price of MSFT shares are likely to drop as a result of the sales

- Cost of the Program is 3.2% of proceeds raised (assuming 100% participation and $27 stock price), which reduces net cash benefit after tax deduction to 29.8% (assuming a 33% effective tax rate)

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[2] Microsoft has requested a ruling from the IRS confirming this treatment
[3] See page 4 of the Attachment for proceeds at various MSFT stock prices

- Microsoft's costs could exceed $29 million, which includes:
  - Up to $15 million to JPMorgan for structuring, evaluating and executing the Program, assuming that 75% of the eligible options are transferred under the Program
  - Up to $12.5 million for registration costs if all of the eligible options are transferred
  - Approximately $2.1 million for filing, accounting and legal fees and printing costs

- Alignment between participants' and shareholder interests is diminished following the transfer
  - However, this is mitigated by the fact that participants currently have exposure to MSFT stock price vis a vis stock options with exercise prices below $33 and new performance/restricted share grants

The Future of Transferable Stock Options

Transferable stock options can also be structured as an ongoing program under which employees would be granted stock options that can be transferred to a third party under certain conditions. This type of program would provide employees with the ability to transfer an option before the end of its term and capture time value in addition to any intrinsic value. The addition of this feature would increase the perceived value of options by employees, thus strengthening the correlation between the cost of the option to the company under FAS 123 and perceived value by marrying the leverage of stock options with the inherent value of restricted stock. Further, an ongoing program can be structured in such a way that normal vesting schedules continue to apply and the sale proceeds are received in company stock rather than cash – thus supporting the shareholder alignment goal for which the options were originally granted.

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MICROSOFT
STOCK OPTION TRANSFER PROGRAM

Eligible Employees – Microsoft employees who hold Eligible Options and were employed during the Election Period in countries other than Belgium, Italy or Pakistan

- Approximately 37,000 employees in 73 countries
- Not available to consultants, advisors or members of Microsoft's Board of Directors
  - Note that Microsoft's top two executives did not participate in the Program

Eligible Options –vested and unvested non-qualified stock options, incentive stock options and stock appreciation rights with exercise prices of $33 or greater, that expire on or after February 29, 2003, and that were outstanding during the Election Period may be voluntarily tendered to Microsoft and "transferred" to JPMorgan

- All of an employee's Eligible Options must be tendered (all or nothing)
- Approximately 624 million Eligible Options (40% of total options outstanding as of June 30, 2003)

Election Period – employees may elect to participate or withdraw participation during the period beginning on October 15, 2003 and ending on November 12, 2003

- Election Period may be extended if (i) disclosure or employee program tools are incomplete or misleading; (ii) the Stock Option Transfer Program is disrupted as a result of regulatory or legislative action that is expected to materially and adversely affect the Program; or (iii) upon Microsoft's request to extend for other circumstances with good faith consideration by JPMorgan
  - Election Period can not be extended beyond November 28, 2003
- Extension of the Election Period could reduce the number of days in the Averaging Period (defined below), which could lead to termination of the Program if a sufficient number of good averaging days are not observed (Program needs at least six good averaging days)
  - Election Period must be at least 20 days

Option Amendments –

- Microsoft Board of Directors has amended the terms of Eligible Options to permit transfer to JPMorgan

- Eligible Options will no longer be authorized under Microsoft's stock incentive plans (i.e., share reserve reduced by options transferred to JPMorgan)

- Option terms will be reduced

  — Generally, options will expire on the earlier of:

    -- Existing expiration for the Eligible Option extended by the number of calendar days from December 5, 2003 to the day prior to the last day of the Averaging Period; or

    -- 36 months from the last day of the Averaging Period

  — Some options, referred to as Multi-Year Grant Options, which were granted to senior executives, will expire 24 months from the last day of the Averaging Period

  — Eligible Options will contain terms and conditions typical of equity option transactions entered into between sophisticated counterparties using standard terms and definitions for equity derivatives published by the International Swaps and Derivatives Association (ISDA), e.g., anti-dilution, merger adjustment, dividends and EITF 00-19 compliant language

    -- However, JP Morgan cannot transfer or sell the options that it acquires under this Program

<u>Option Valuation</u> – amended options will be valued using the binominal option pricing model based on the truncated term, estimated future volatility, option exercise price and the MSFT average closing stock price during the Averaging Period

- Estimated future volatility is lower than MSFT's historic volatility since volatility is expected to decrease as a result of JPMorgan's hedging activities

  — JPMorgan will adjust its hedge position as MSFT's stock price increases or decreases, which will have the effect of reducing MSFT volatility

<u>Averaging Period</u> – begins no later than the 1st business day following the second calendar day after the election deadline (i.e., November 17, 2003 if the Election Period is not extended) and ending on and including the earlier of (i) December 15, 2003 or (ii) the 15th available trading day (i.e., trading day means no market interruption, Microsoft registration statement is available, etc.)

- If Averaging Period is less than 5 days (due to extension of election deadline or events that preclude days from being available trading days), the Program will be terminated

<u>Vesting Period</u> – payment amounts in excess of $20,000 will be subject to a vesting period, which varies based on employee level

- Delayed payments earn monthly interest credits at the 3-month US treasury bill yield adjusted for constant maturity, compounded monthly on an actual 365 day basis

- The following table shows the payment schedule for employees in the US and countries other than Australia, Canada, Czech Republic, Denmark, Finland, Germany, Hungary, India, Japan, Netherlands, Poland, Singapore, Spain, Trinidad & Tobago or Venezuela:

Expected Payment Schedule (% of Total Payment)				
		If Continuously Employed by Microsoft		
		Through the Election Deadline	Throughout the 2 years from the last day of the Averaging Period	Throughout the 3 years from the last day of the Averaging Period
If amount of the Total Payment is:	Employee Level at Election Deadline	Distribution no later than 12/31/03	Distribution no later than 12/31/05	Distribution no later than 12/31/06
$20,000 or less	Any	100%	N/A	N/A
$20,000.01 or more	Levels 54-67	Greater of 33.33% or $20,000	Remainder plus interest equivalent	N/A
	Levels 68+	Greater of 33.33% or $20,000	50% of the remainder plus interest equivalent	Remainder plus interest equivalent

— The final vesting for Levels 68+ employees is set to coincide with the vesting of the new performance share program (i.e., the Shared Performance Stock Award Program)

Effect of Termination of Employment During the Vesting Period – forfeiture of unvested payments and interest, unless death or disability termination

- Death and Disability – entitled to any payment plus interest that would have vested within 12 months following termination; payment made promptly following termination

Payment- will be made in cash, net of withholding tax, at the end of any applicable vesting periods

- The following table illustrates the total payments to be made at different average closing prices if all of the Eligible Options are transferred

Total Payments for All Eligible Options At Average Closing Prices		
$22	$27	$32
$313 million	$919 million	$1.975 billion

- Payments are not benefit-bearing

Impact of Program Termination – if the Program is terminated, employees who elected to participate in the Program will retain all of their Eligible Options

- Options will retain their original terms (i.e., maximum term 10 years)

Tax Treatment – Microsoft has requested a ruling from the IRS confirming the following:

Employees

- Recognize ordinary income tax on payments received under the Program; payments will also be subject to federal employment, state, local or foreign taxes
  - ISOs that are transferred under the Program will lose tax qualified status
- Microsoft believes that there are no tax implications if the Eligible Options are not transferred; however, the IRS could characterize the opportunity to participate in the Program as a modification, in which case ISOs that are not transferred would lose their tax-qualified status

Company

- Microsoft does not recognize income on the issuance of options to JPMorgan since it is considered to be a capital transaction
  - Issuance is taxed under Section 1032 of the Internal Revenue Code (i.e., no income is realized on the purchase or sale of company stock)
- Entitled to a tax deduction at the same time and on the same amount as employees recognize income

- However, amounts paid to five highest-paid executives will not be deductible as performance-based compensation under Section 162(m) if paid while a named executive officer

Accounting – under FAS 123, the Company will incur a charge to earnings equal to the unrecognized compensation cost of unvested eligible options that are transferred under the Program

Shareholder Approval – Given Microsoft's plan, not required under Nasdaq rules[1]

- Note, however, that Institutional Shareholder Services (ISS) indicated in its Proxy Analysis report that its preference would have been for the Program to have been put to shareholder vote

  - Rationale for desiring shareholder vote is that the Program "represents an alternative to repricing stock options and constitutes a significant amendment to the company's stock compensation program", which has an economic impact on shareholder value

Microsoft Costs Associated with Program

- Up to $15 million to JPMorgan for structuring, analyzing, and executing the Program

  - Consists of (i) engagement fee of $6 million; (ii) execution fee of $4 million if more than 50% of the eligible options are transferred under the program; and (iii) supplemental execution fee of $5 million if more than 75% of the eligible options are transferred under the program.

- Also pay a cost reimbursement fee equal to $0.02 for each share sold by JP Morgan under the registration statement, not to exceed the number of underlying options transferred

  - Approximately $12.5 million if all Eligible Options are transferred and JPMorgan sells same number of shares ($0.020 X 624 million shares)

- Additional costs of approximately $2.1 million to cover filing expenses, accounting and legal fees and printing

JPMorgan Activities

- Microsoft filed a registration statement to enable JPMorgan to sell shares (up to the number of options that are transferred) to hedge its exposure to the ownership of the transferred options and in connection with the Program

[1] While not applicable to Microsoft, the NYSE has also indicated that this program would not require shareholder approval

- Sales will occur during the Averaging Period to established the desired hedge

  — JPMorgan is expected to sell equal shares on each day of the Averaging Period

  — Sales could have the effect of decreasing the stock price, which would result in lower payments to employees for the transferred options

- During the Election Period and Averaging Period and after the Averaging Period, JPMorgan expects to sell additional shares to comply with regulatory requirements (i.e., to introduce into the market with prospectus delivery an amount equal to 100% of the shares underlying the transaction)

  — These shares, together with the shares sold to establish the desired hedging, will equal the total number of options transferred under the Program

  — Additional shares will not be used to establish the hedge

  — JPMorgan expects to purchase MSFT shares on the same days that it sells the additional shares in order to maintain its desired hedge position

  — During and after the Averaging Period, JPMorgan may continue to purchase or sell MFST shares to adjust its hedge position

    -- JPMorgan is not restricted from engaging in hedging or other market transactions that are unrelated to the Program

- JP Morgan Securities intends to offer the shares acquired under the registration statement to the public from time to time for sale in transactions, including block sales, in the over-the-counter market, in negotiated transactions or otherwise at market prices prevailing at time of the same or at prices otherwise negotiated