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A RETREAT FROM OPTIONS:
MICROSOFT'S NEW STOCK-COMPENSATION PROGRAM

Microsoft's recent announcement that it will no longer grant stock options to its employees and will allow underwater options to be sold has created a great deal of interest in the business community. This letter outlines the program changes, discusses several issues and presents the pros and cons of such actions.

Background

On July 8, 2003, Microsoft announced that it would discontinue granting stock options to its employees and switch to awarding restricted stock units which vest over a five-year period and will be paid out in shares. In doing so, Microsoft becomes one of the first major technology companies to abandon the use of stock options for the future as an incentive tool for employees. The Company noted that the new strategy provides more stability and predictability of compensation which it believes will be helpful both in attracting and retaining people.

The new program addresses Microsoft's concern about the dichotomy between different groups of employees' compensation because long-time employees have received substantial value from their options and newer employees have not. Microsoft also announced that it plans to implement a program in the near future that will allow employees to sell their currently outstanding underwater options to a third party, JP Morgan Chase & Co. (JPM).

As part of this transition, the Company also announced that it would change its accounting practices with regard to stock-based compensation and begin accounting for awards under FAS 123. In adopting FAS 123, the company chose to voluntarily restate prior financial results in addition to expensing for future stock-based awards.

Details of the New Program

Under the new program, all Microsoft employees are eligible to receive annual grants of restricted stock units. Each unit represents the right to receive one share of Microsoft stock in the future. These units differ from traditional restricted stock in two distinct ways:

1) Dividend equivalents are not paid on the units

2) Employees will not be able to make an IRC §83(b) election (normally available with traditional restricted stock) which allows the holder to be taxed immediately on the value at grant at ordinary income rates, and to have subsequent appreciation treated as capital gains

In addition to receiving annual restricted stock unit awards, the top 1% of the Company's employees (approximately 600 executives[1]) will also receive "shared-performance stock awards" based on three-year non-overlapping performance periods. These award opportunities will be significant, and will be earned based on several measures of performance, including the number and satisfaction of Microsoft customers over a designated time period.

In the initial three-year performance period, executives are guaranteed to receive at least one-third of the target award and the payments are capped at one and one-half times the target award. It is currently presumed that future performance periods will not contain a guaranteed payment or "floor."

Transferable Options

Pending approval by the SEC, Microsoft plans to allow employees to sell both vested and unvested underwater options to JPM for cash. This is a one-time opportunity, and any employees who elect to participate would be required to sell all of their existing underwater options with prices above a certain threshold, e.g., $33, as a single tranche. Estimates provided by JP Morgan indicate that an option with an exercise price of $33 would be worth about $2 if the Company's current stock price were $25. For options with higher exercise prices, the cash value received by the employee would be lower.

As part of the transaction, Microsoft would reduce the term of the option and the cash proceeds of the sale would be paid to the employee over a three-year period (i.e., one-third payable immediately, one-third payable twelve months later and the final one-third payable twelve months after that).

It is unclear what JPM will do with the options once they have bought them or how many will actually be cashed in. According to the Company, approximately 600,000,000 options have exercise prices above $33 per share. This would leave about 1 billion options outstanding if all employees elected to sell. However, it is possible that many of the senior executives of the Company will not accept the exchange offer and will still continue to have a leveraged opportunity going forward.

Considerations on the Change from Options to Restricted Stock:

The technical and design issues here are fairly straightforward and include:

- The ratio used to exchange options for restricted stock and the resulting accounting impact

[1] Microsoft's CEO, Steve Ballmer, and its Chairman and Chief Software Architect, Bill Gates, will not receive stock awards.

- The Company noted no specific exchange ratio was targeted for the change from options to restricted stock units. The approach for senior people was to determine a market position for total direct compensation, and all other awards were determined in a layered fashion to other grade levels.

- Presumably the Company has structured the exchange so the accounting charges under the new program will be lower than they would have been under the old program

* The final payment vehicle

  - Even though the grants are in the form of restricted stock units, using stock for the payment preserves fixed accounting so the charges are predictable

* Need for more restricted shares under the current plan

  - The Company's 2001 Stock Plan allows for a maximum of 50,000,000 shares that could be used for restricted stock unit awards. The Company may need to go back to shareholders to increase this allocation for future years.

Technical Considerations on the Option Sale Program:

This transaction has raised many technical questions, particularly since many of the details are not yet known:

* Option Transferability

  - Incentive stock options (ISOs) are not transferable. Non-qualified stock options are generally not transferable except to family members or trusts

    - A review of Microsoft's 2001 Stock Plan indicates that transferability may be possible because, while transferability is generally limited to transfers by will or the laws of descent or distribution, the Plan also states that "the Board may permit further transferability"

    - Also, the Plan could be amended by the Board to more directly permit transferability because the Board has the authority to "amend or terminate the Plan from time to time in such respects as the Board may deem appropriate"

  - We understand that Microsoft has asked the SEC to verify that the amendments made by the Company to transfer the options to JPM are permitted, but it is unknown whether the SEC has responded to date

- Registration of Options:

  - The SEC does not require stock options granted to employees to be registered. The shares that will be issued when options are exercised can be registered on a Form 8, leveraging off other company filings. This is a much simpler and less expensive registration process than a full-blown registration of company securities. It is possible that the options sold by employees to JPM will need to be registered before they can be resold to other entities.

- Tax Implications for the Options that are Sold:

  - Presumably, once the options are sold to JPM, the Company will not be able to take a tax deduction for any gain at exercise as they would with a normal option exercise or the exercise of an option that had been transferred to a family trust. Presumably there would also be no deduction for the cash payment.

- Tax Implications for Future Stock Option Awards

  - Employee stock options are not taxed at grant because there is no established market value; however, if future options may also be sold at Microsoft, there will be a value and employees may be taxed as soon as they are able to sell the options

Pros and Cons for the Program Changes and Sale of Options

<u>Pros:</u>

- This change will provide more certain value to employees
- Long-time employees and newer employees will receive similar compensation values
- The Company's run rate from stock grants will be reduced
- The Company's accounting charge under FAS 123 will be more aligned with the value delivered
- The top executives still have performance requirements to receive the bulk of their awards
- Employees are able to receive value from underwater options

<u>Cons:</u>

- This action may signal to the market that the Company does not believe its stock price has significant potential for appreciation in the future
- Shareholders may not approve plans in the future if options can be sold

- Future grants of stock options, if any, may be immediately taxed

- Executives at Microsoft may not be perceived as having the same degree of risk in their incentive program as with options

- Restricted shares are typically viewed as more of a retentive device than an incentive one

What the Future May Hold With Regard to Option Sale Programs

If Microsoft and JPM are successful in this endeavor, we may see other companies follow suit. Going one step farther, we could see companies allowing employees to sell not only underwater options but also in-the-money options at any time after the options vest to third parties in exchange for cash and/or company stock.

Under this new system, employees would be given greater flexibility to manage their financial liquidity needs. In addition, employee option sales would provide employees with compensation that they normally would never have been able to capture -- the time value of the option. Currently, employees who exercise options only receive the spread on the stock. However, if options were to become freely tradable through a third party, then employees would realize not only the intrinsic value on the option (provided it is in-the-money) but also the time value left on the option.

According to one investment bank, these types of programs, called on-going tradable option programs, are already in place in Europe for a limited number of companies, but not disclosed. It may be only a matter of time before companies in the United States begin to explore this unique approach to compensation, particularly if companies are required to expense a Black-Scholes option value greater than the perceived value to employees.

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General questions about this letter can be addressed to Beverly Aisenbrey or Louis C. Taormina in our New York office at 212-986-6330 or by e-mail at bwaisenbrey@fwcook.com or lctaormina@fwcook.com. Copies of this letter and published materials are available on our website at www.fwcook.com.

Please note that on August 13, 2003, WorldatWork will be offering a fee-based web seminar titled "In the Wake of Microsoft: Restricted Stock vs. Stock Options." The seminar will be hosted by George Paulin, CEO of our firm, and Brit Wittman, Human Resources Manager at Cisco Systems. More information about this unique seminar can be found on our website or at www.worldatwork.org/feature/webinar2.html.