February 9, 1998

Summary of 1997 Legislative and Other
Developments Affecting Executive Compensation

This letter summarizes significant developments affecting executive compensation during 1997. The footnotes following each section heading refer to our earlier letters that address these issues in greater depth.

The most significant regulatory development in 1997 was the release of Statement of Financial Accounting Standards No. 128, which governs the calculation and disclosure of earnings per share, followed by the release of interpretive guidance under Securities and Exchange Commission (SEC) new Rule 16b-3, which was released in 1996. The year was also marked by important developments that affect executive compensation planning, including tax law changes affecting capital gains rates and continued public scrutiny of rising shareholder dilution levels attributable to stock plan grants.

STOCK PLAN ACCOUNTING ISSUES

New Opinion 25 Project[1]

The Financial Accounting Standards Board (FASB) commenced a project to address and resolve 12 important practice and interpretive issues that have arisen under Opinion 25, "Accounting for Stock Issued to Employees."

Opinion 25 sets forth the governing principles for determining expense recognized by a company for stock options and other equity grants made to employees. Important issues being addressed include whether grants to outside directors can be accounted for under Opinion 25, whether acceleration of vesting or the modification of other terms will cause a new measurement date, and whether the measurement date for grants made contingent on shareholder approval is deferred until such approval is obtained. With regard to the last issue, it should be noted that the SEC has already taken the position that in such cases, compensation expense must be recognized equal to stock price growth between grant date and approval (we expect this to influence the FASB).

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[1] Alert Letter, *FASB Identifies Issues to be Resolved by New Opinion 25 Project*, January 10, 1997

It should also be noted that while employee stock purchase plans (ESPPs) were not among the original issues the FASB intended to examine, it now appears they will readdress whether ESPPs with look-back features should be treated as noncompensatory. If the FASB rules that such plans are not noncompensatory (as it did in FAS 123), an earnings charge equal to the entire spread at exercise may result, which would greatly reduce the appeal of such plans to employers.

New Earnings Per Share Accounting Standard[2]

On March 3, the FASB issued "Statement of Financial Accounting Standards No. 128," which is effective for interim and annual financial statements issued after December 15, 1997.

The new standard requires all public companies with outstanding stock options and other stock-based awards to compute and disclose two forms of earnings per share (EPS), including one that illustrates the dilutive effect of outstanding awards (diluted EPS) and one that does not (basic EPS). Under the previous rules, companies were required to include the dilutive effect of stock-based awards only if such inclusion diluted EPS by 3% or more.

The dual reporting requirements under the new standard, coupled with the pro forma footnote disclosures required under FAS 123, could significantly improve the public's ability to assess potential dilution associated with stock-based plans.

Fixed Accounting for Stock Option Gain Deferrals[3]

Many companies have enhanced their stock option plans by allowing pretax deferral of option gains in share units. The Emerging Issues Task Force (EITF) of the FASB has clarified that, under certain circumstances, pretax deferral of stock option gains does not result in a new measurement date and additional compensation expense under Opinion 25.

To avoid variable accounting, the option should be exercised using mature shares (i.e., those owned at least six months) and the deferral should be credited in stock units, payable in real shares. The EITF has stated that the ability to convert the deferral into an alternative investment account would result in a new measurement date, and hence a variable expense.

Trends in 1997 FAS 123 Footnote Disclosure[4]

In an effort to assess developing practice regarding FAS 123 compliance, we examined the annual reports of a random sample of 100 public companies with annual revenue in excess of $1 billion and fiscal years beginning after December 15, 1995.

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[2] Alert Letter, *New Earnings Per Share Accounting Standard May Shed More Sunlight on Stock-Based Compensation*, March 17, 1998
[3] Alert Letter, *FASB Affirms Fixed Plan Accounting for Deferrals of Stock Option Gains under Limited Circumstances*, July 25, 1997
[4] Alert Letter, *1997 Disclosure of FAS 123 Stock Option Valuation*, April 17, 1997

As expected, none of the companies chose to adopt FAS 123 for expense recognition purposes. Interestingly, we found that 21% determined the pro forma impact on net income and earnings per share to be immaterial and decided not to report it. Our findings indicate most companies reported a pro forma reduction in EPS of between 0% and 3%, but we expect this figure to increase in future years as additional awards are included (pre-1995 option grants are not included in the calculation).

The median option term for calculating present values was 5.4 years, and over 10% used 9 or 10 years as the expected life (which we assume was the result of having insufficient exercise history to justify a lower number). Almost 70% of the companies reported stock option fair values of less than 30% of average grant price and only 3% reported fair values of 40% or more.

Proposed Bill Threatens Stock Option Accounting Treatment[5]

Introduced in April 1997 by Senators Carl Levin and John McCain, a bill entitled "Ending Double Standards for Stock Options Act" proposes to limit the corporate tax deductions on employee stock option gains to an amount recorded as an expense on a company's financial statements. Alternatively, the deduction could be preserved if substantially all U.S.-based employees are eligible to receive options, no single individual receives more than 20% of the total amount granted during the year, and at least 50% of the options are granted to non-management employees.

This proposal is inconsistent with existing accounting rules regarding the expensing of stock options, since expense is not recognized on "plain vanilla" options under Opinion 25 and virtually no companies have elected to adopt FAS 123 for expense recognition purposes. Even in the event a company adopts FAS 123, the rules require that options be expensed on a "fair value" basis, which would inherently limit the potential deduction available to most companies to less than 40% of the grant price (see above summary regarding FAS 123 footnote disclosure and fair value estimates).

If passed, this bill would have dramatic effect on the use and the design of option programs. Given the accounting inconsistencies, it is likely that many companies would extend option grants deeper into the organization, which would result in additional shareholder dilution.

SECURITIES AND EXCHANGE COMMISSION[6]

Effective November 1, 1996, the SEC adopted new Rule 16b-3, which provides exemptive relief from the short-swing profit recovery rules applicable to compensatory stock-based insider transactions. Shortly after the effective date, the SEC staff released several interpretative letters that address issues raised by the new Rule.

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[5] Alert Letter, *Proposed Bill—No Tax Deduction if No Expense for Stock Options*, May 9, 1997

[6] Alert Letter, *SEC Issues Interpretations to Rule 16b-3*, January 15, 1997

As background, the short-swing profit recovery rule functions to prevent insiders from unfairly using confidential information to profit from short-term trading in their company's securities. Profits realized by an insider that result from buying and selling their company's equity securities within a six month period are subject to potential disgorgement back to the Company. Under the new Rule, there are four categories under which a transaction may obtain exemptive relief:

- The transaction occurs under a tax-qualified plan or a clone plan designed *solely* to provide benefits that, in the absence of regulatory restrictions, would otherwise be paid under the qualified plan

- The receipt of a grant or award is approved by a committee of two or more "non-employee directors," the full Board, or shareholders. Alternatively, the grant or award and underlying securities could be held by the recipient for at least six months

- A disposition of stock to the company by an insider (e.g., cash settlement of stock-based award, stock tendered to exercise options or shares withheld to cover taxes) is approved by a committee of two or more "non-employee directors," the full Board, or shareholders

- The transaction is volitional or "discretionary," such as those that occur in a savings or deferred compensation plan in which cash in converted into stock or stock units (or vice-versa), and the election triggering the transaction occurs at least six months after any prior election triggering an opposite way transaction

In addressing the above issues, the SEC staff issued interpretive letters that examine questions about:

- Who qualifies as a "non-employee director," which generally excludes anyone who earns in excess of $60,000 (other than for Board duties) from the company, has a pecuniary interest of over $60,000 that requires proxy statement disclosure, or is engaged in any other business relationship that requires proxy statement disclosure

- What qualifies as a "discretionary transaction," which generally includes volitional fund switching (regardless of whether real stock or stock units are involved) or voluntary cash-outs of plan stock that result from market sales

- The types of transactions that qualify for exemptive relief in tax-qualified plans

In addition, the SEC staff also specified that subsequent acquisitions or dispositions that occur in conjunction with grants and awards that were exempted under one of the predecessor Rules must meet the conditions of the new Rule to secure a purchase or sale exemption.

TAX LAW CHANGES PRESENT PLANNING IMPLICATIONS[7]

The tax law changes implemented as part of the Taxpayer Relief Act of 1997 present significant planning implications regarding executive compensation. The most significant tax change is the reduction in capital gains rates, which:

- Makes the use of incentive stock options more attractive, since the reduction in capital gains rates enhances the potential value to executives relative to the cost to the company

- Enhances the potential value of reload options, since early exercise and conversion into full-value shares increases the portion of an individual's total carried interest potentially subject to capital gains rates

- Reduces the value of deferred compensation (which is subject to ordinary income tax when distributed) relative to taxable investments that are potentially eligible for capital gains treatment, but only to the extent that significantly higher rates of return are available outside the plan

- Increases the potential value of making a Section 83(b) election relative to the risk of overpaying taxes in the event of forfeiture

In addition, since reduction in the capital gains rate could encourage early exercise of stock options, it could also have the effect of raising the base amount for determining the amount of excess parachute payments in the event of change in control.

POTENTIAL NEW FORM OF STOCK OPTION BEING CONSIDERED[8]

Introduced on October 31, "The Employee Stock Option Bill of 1997" proposes Employee Stock Options (ESOs) as a new form of incentive stock option (ISO). Like ISOs, there would be no tax due at exercise of an ESO, and assuming at least 50% of shares granted in any year are awarded to non-highly compensated employees, ESOs carry the following additional benefits:

- The maximum annual vesting limit would be $200,000 (vs. $100,000 in ISOs)

- The gain at exercise would not be taxed if the shares are held at least two years from the date of grant *or* one year from option exercise (the ISO holding period is two years from grant and one year from exercise)

- The gain at exercise would not be a tax preference item for purposes of the alternative minimum tax

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[7] Alert Letter, *Executive Compensation Implications of Changes in Tax Law*, August 22, 1997
[8] Alert Letter, *Legislation Introduced for New Form of Stock Options*, November 13, 1997

Like ISOs, the disadvantage of ESOs is the loss of the corporate tax deduction for option gains when the required holding periods are met. As mentioned above, however, recent reduction in capital gains rates makes the tax benefits to employees more attractive relative to the cost to the company.

VOTING ON STOCK PLANS[9]

As the size of stock option grants continues to escalate and potential dilution rises as a result, negative shareholder votes on stock plans have increased significantly in recent years. In determining how to vote on new stock plan proposals, many institutions rely on guidance from Institutional Shareholder Services (ISS), which makes recommendations based on the plan's particular features and the associated cost and dilutive impact based on industry-specific comparisons.

In response to the risk of a negative vote recommendation, many companies are closely examining their stock plans within the context of ISS's methodology prior to submitting them for shareholder vote. To better educate companies in understanding their proxy voting policies, ISS has recently made a simplified version of its model (i.e., ISSue Compass) available through its website for a fee. Through an interactive process that allows modeling of alternative plan designs, companies can assess the likelihood of receiving a positive vote recommendation and make changes if necessary.

CORPORATE GOVERNANCE[10]

Increased public scrutiny and pressure on boards of directors to provide effective leadership has raised overall interest in corporate governance policies. In recent years, several organizations have published recommended corporate governance principles to enable organizations to quickly and effectively respond to situations that affect the health of the business, such as changes in leadership and business downturns.

In September 1997, the Business Roundtable (BRT) issued its revised statement on corporate governance. The BRT statement addresses three primary areas, which include functions of the board, structure and operation of the board, and stockholder meetings. It presents some specific and useful views on the importance of director independence and proper board operation that can assist companies when addressing evaluation and selection of top management, management compensation, approval of major strategies and financial objectives, selection of board candidates, board structure and performance, board committee structure and functions, board compensation, management and stockholder proposals, and other key governance issues.

It should be noted that in several ways, the BRT statement differs from guidance released by institutional investors, such as TIAA-CREF and CalPERS.

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[9] Alert Letters, *Stock plan Dilution and Negative Shareholder Votes*, February 13, 1997; *ISS's Stock Plan Valuation Model on the Web*, December 12, 1997

[10] Alert Letter, *Corporate Governance—The Business Roundtable Issues Its Statement and CalPERS Plans to Survey Corporations*, November 17, 1997

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Please refer to the alert letters referenced in the footnotes and the following summary for more detail on the topics summarized above. Additional information can be obtained by contacting Dan Ryterband in the New York office at (212) 986-6330 or any other member of the firm. This letter and other published materials are available on our web site, **www.fredericwcook.com.**

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