Frederic W. Cook & Co., Inc.

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Executive Compensation Implications
of the Sarbanes-Oxley Act of 2002

Overview

On July 30, 2002, in the interests of restoring investor confidence, President Bush signed into law the Sarbanes-Oxley Act of 2002[1] ("the Act"). This new legislation strives to protect investors by enhancing corporate responsibility, revamping corporate governance and financial reporting obligations, and strengthening the punishments for crimes in connection with corporate fraud. The Act generally applies to all SEC-registered U.S. and non-U.S. companies.

There are many elements to this legislation, including the establishment of a Public Company Accounting Oversight Board, increased financial disclosure requirements, increased auditor independence and audit process oversight. The focus of this letter, however, will be limited to those aspects specifically related to executive compensation.

Executive Compensation Implications

Outlined below are those sections of the Act that are applicable to executive compensation:

1. Prohibition of loans to executive officers and directors

   Effective July 30, 2002, a company may not extend, arrange for, or renew credit in the form of a personal loan to executives or directors of a company. Existing loans made to executives or directors will be "grandfathered." However, no modifications to an existing loan may be made after the effective date of the law.

   Certain exceptions are provided, however, for companies generally engaged in a lending or credit business. These include home improvement and manufactured home loans, consumer credit arrangements or extensions of credit under an open end credit plan, charge cards, and with respect to a registered broker or dealer, any extension of credit to buy, trade or carry securities other than credit used to purchase stock of that issuer.

   It is not clear if the Act prohibits split-dollar life insurance policies (due to the loan characteristics of these arrangements), or participant loans from 401(k) plans. Also called into question are broker-assisted cashless exercises of stock options, on the theory that the company is extending (or arranging) credit to the optionee pending the sale of the stock into the market and payment of the exercise price. In addition, the Act does not address whether outstanding loans to executives at non-reporting companies that later

[1] A copy of the Act can be accessed through the following link, Sarbanes-Oxley Act of 2002

become reporting companies (e.g., private companies that become publicly traded) will be grandfathered.

2. Accelerated SEC Reporting

Effective August 29, 2002, Section 16(a) of the Securities Exchange Act of 1934 will be amended to require executive officers, directors, or beneficial owners of more than 10% of a company's stock (i.e., principal stockholders) to file a Form 4 within two business days of a transaction involving changes in their equity holdings including purchases or sales of swap agreements. Previously, these individuals were required to file within ten days following the end of the month in which the transaction occurred. As part of the implementation of this requirement, the SEC will also require all exempted transactions currently reportable on Form 5 (e.g., issuances, cancellations, regrants and repricings of stock options) within forty-five days after the issuer's fiscal year-end to be reported within two business days on Form 4 also. Form 5 filings would remain available for certain *de minimus* acquisitions and certain transactions that are exempt from liability under Section 16(b). Finally, a Form 3 must be filed within ten days of an individual becoming an officer, director or principal stockholder, reflecting no change from the previous requirement.

No later than one year after enactment on July 30, 2003, all Form 4 statements must be filed electronically with the SEC and posted on a company's website no later than the next day after filing. Currently, companies may file these forms on paper with the SEC, making them less accessible to the public.

3. Forfeiture of Compensation

Effective July 30, 2002, if an issuer is required to restate its financial statements due to noncompliance with disclosure requirements due to misconduct (although this term is not defined in the legislation), the Chief Executive Officer and Chief Financial Officer must reimburse the company for any bonuses, incentive-based or equity-based compensation, and any profits realized from the sale of stock in the company within the twelve months following the first filing or public issuance of the non-compliant statement. The Act is unclear when a restatement is required, or what occurs in the event of a voluntary restatement.

There is an issue here with respect to how the provision would apply to stock-based compensation, in particular, with respect to stock options and restricted stock awards. It is unclear whether the compensation forfeited would include grants made during the period in addition to amounts that were actually realized (e.g., vesting of restricted shares, or profits from any options exercised).

4. Prohibition of Insider Trading During Pension Fund Black-Out Periods

Effective 180 days after enactment, officers and directors will be prohibited from purchasing, selling, or otherwise acquiring or transferring equity securities of the company during "black-out" periods when employees of the company are prohibited from selling stock in a 401(k) or other defined contribution arrangement (i.e., a plan subject to ERISA). If such a violation should occur, the shareholders of the company may sue the officer or director to recover the profits earned as a result of the violation. The SEC may further clarify these rules to include, for example, exemptions for dividend reinvestment programs or purchases and sales made pursuant to an advance election under SEC Rule 10b5-1 programs.

5. Criminal Penalties for ERISA Violations

The fines and jail time imposed for violation of ERISA have been increased substantially. As amended, the maximum fine for a violation by an individual has been increased from $5,000 to $100,000, and the maximum jail term has been increased from one year to ten years. The maximum fine for a corporation has been increased from $100,000 to $500,000.

Conclusion

Outlined above are the main executive compensation related aspects of the Act. There are a variety of open issues related to the Act that require clarification from the SEC. It is not clear at this point when such clarification may be forthcoming. In the interim, companies should discuss relevant issues with appropriate counsel to obtain guidance.

The Act is just one of the many governance initiatives affecting this executive compensation today. Our letters on other relevant governance actions, such as the New York Stock Exchange governance proposal and the stock option accounting debate, can be accessed on our website.

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General questions related to this letter may be addressed to Michael Chavira in our New York office at (212) 986-6330. Copies of this letter and other published material are available on our website at www.fwcook.com.