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New York • Chicago • Los Angeles

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Executive Compensation Year in Review (2003)

Following on the dramatic regulatory changes of 2002, 2003 saw many significant developments in the field of executive compensation. The following is a review of key accounting, regulatory and legislative developments of 2003 that impact the field of executive compensation. The purpose of this memo is not to provide a comprehensive analysis of these changes, but to highlight 2003's developments and their implications for executive compensation programs.

> In 2003 the onset of stock option expensing became more of a reality with the FASB continuing its deliberations, and final standards on stock option expensing expected to be released by late 2004. Shareholder approval requirements for equity compensation plans were tightened by the NYSE, shifting more of the balance of power from the Board of Directors to shareholders. The disclosure of insider stock transactions was improved, with the SEC mandating the electronic filing of beneficial ownership reports. With these steps, the regulators and other interested parties sought to fix some of the excesses brought on by the stock market boom of the last decade.

Additional details for each of the summaries below may be found in corresponding "alert" letters on our website at www.fwcook.com. The information is arranged under the following five categories:

1. **Accounting**
2. **Stock Exchanges**
3. **SEC**
4. **IRS/Taxation**
5. **Other Governance Initiatives and Compensation Developments**

1. Accounting

- On December 31, 2002, The Financial Accounting Standards Board (FASB) issued FASB Statement No. 148 (Statement 148), Accounting for Stock-Based Compensation Transition and Disclosure. All transition and disclosure provisions of Statement 148 were effective for fiscal years ending after December 15, 2002 (that is, for 2002 calendar year financial statements).

Statement 148:

— Allowed companies that voluntarily adopt Statement 123 to choose among three transition alternatives (prospective application to new awards, prospective application for new and nonvested prior awards, and retroactive restatement for all prior awards)

  -- Note that the prospective application to new awards transition method was not permitted for companies voluntarily adopting Statement 123 in fiscal years beginning after December 15, 2003

  -- For companies electing the retroactive restatement transition method, the restated amounts were required to be consistent with numbers reported in prior period pro forma net income and earnings per share footnote disclosures

— Required certain information on stock compensation to be disclosed in the "accounting policy" footnote of annual and interim financial statements and reports (most notably, the pro forma net income and earnings per share disclosure required for companies accounting for stock compensation under APB Opinion 25).

Implications: The above transition alternatives were provided to induce companies to voluntarily adopt Statement 123 as we await the FASB's final rules on option expensing. However, note that the prospective application to new awards transition method is no longer permitted.

(For further information see the alert letter dated 1/10/03)

- In 2003 the FASB continued to make progress revisiting the provisions of its statement of Financial Accounting Standards No. 123 (FAS 123). Key developments in this project included:

— The FASB decided that employee stock-based compensation should be recognized as an expense in financial statements, based on "fair value" measurement, and using a "modified grant date" and cost attribution approach as outlined in FAS 123, i.e., no Opinion 25 exception

  -- The modified grant date approach is essentially the same as measuring compensation cost on the grant date, except that previously recognized compensation cost is reversed if stock-based awards are subsequently forfeited because of an employee's failure to fulfill a "service" or "performance" condition. A service condition is one that is based solely on an employee's rendering services to the company for a specified period of time, and a performance condition is one that is based on achieving a specified performance target that is referenced solely to the company's own operations or activities

- -- Compensation cost is recognized, either on a pro rata or an accelerated basis, over the service period, which is generally presumed to be the vesting period

— The FASB formed an "Option Valuation Group" (OVG) to advise on several FAS 123 option valuation issues

— The FASB on October 29, 2003 tentatively decided that, for public companies, the proposed standard would be effective for fiscal years beginning after December 15, 2004, i.e., 2005 financial statements for calendar year companies. Earlier adoption in 2004 would be encouraged, assuming the final standard is released in the fourth quarter of 2004 as planned

-- Companies would be required to adopt the new standard using a "modified prospective" method, meaning that "equity-based compensation" (EBC) cost would be recognized for all employee awards granted, modified, or settled after the effective date, plus the nonvested portion of awards granted or modified in fiscal years beginning after December 15, 1994

— Separately, the International Accounting Standards Board's (IASB) final standard on "Share-based Payment," is effective for fiscal years beginning on or after January 1, 2005, on a modified retroactive basis for all awards granted after the November 7, 2002 release of the IASB Exposure Draft (ED), with full retroactive application permitted for companies previously disclosing FAS 123 costs in financial statement footnotes

Implications: While the pace of developments has been slow, the onset of stock option expensing has become more of a likelihood. The most important outstanding issue in this area is the methodology for valuing stock options. It is expected that a modified version of the Binomial option pricing model will be adopted.

If the FASB's proposed option expensing guidelines are adopted, the financial efficiency of stock options will be substantially reduced due to the requirement to expense their "fair value", which can create a cost that is greater than the options' perceived value, and the inability to reverse expense for options that never provide value and expire unexercised. Other award types will also become more attractive due to the "level playing field" created by option expensing. Overall, we expect long-term incentive grant levels will decrease as companies are required to include the cost of these awards in their income statements.

(For further information see the alert letters dated 6/23/03, 9/18/03 and 11/05/03)

2. Stock Exchanges

- The New York Stock Exchange released its final rules regarding shareholder approval requirements applicable to equity compensation plans. Subsequently it also released two sets of frequently-asked questions ("FAQs"). The rules became effective June 30, 2003. The most important provisions of these rules are as follows:

- All "equity compensation plans," and any "material" revisions to such arrangements, must be subject to shareholder approval
  - "Equity compensation plan" is generally defined to include a plan or arrangement that provides for the delivery of equity securities to any employee, director, or other service provider as compensation for services
  - "Material" revisions to equity compensation plans include increases in the number of shares authorized under the plan (excluding the effects of stock splits, spin-offs, etc. and increases due to evergreen features), expansion in the types of awards available under the plan, extension of the term of the plan, etc.
- Any plan that does not contain a provision that specifically permits repricing is deemed to be one that prohibits such action and therefore requires shareholder approval if a repricing is adopted
- The treasury stock exception is no longer available. However, use of treasury stock is still permissible for arrangements in which shareholder-approval is not required (e.g., new hires, deferral programs)
- The following exemptions from the shareholder-approval requirements are available:
  - Stock option and other equity incentives made in conjunction with the initial hiring of an employee are exempt so long as promptly following the grant of an award, the company discloses in a press release its material terms, including the recipients and the number of shares
  - Shareholder approval is not required to convert, replace, or adjust outstanding equity awards to reflect mergers or acquisitions
  - Tax-qualified plans, such as those that meet the requirements of IRC section 401(a) and 423, are exempt from the shareholder-approval requirements, as are any parallel nonqualified plans that restore benefits that would otherwise be paid in the absence of IRS limits
- When exemptions to the shareholder-approval requirement are available, the plans and amendments must be approved by an independent compensation committee or by a majority of the independent members of the board
- The rules prohibit member organizations (i.e., brokers) from giving a proxy to vote on equity compensation plans unless specific instructions to do so have been given by the owner of the shares

***Implications:** The final rules address long-standing shareholder concerns applicable to share dilution from non-approved plans and the repricing of outstanding stock options. The net*

effect is a significant shift in the balance of power away from the Board of Directors to shareholders.

Note that the NASDAQ rules are not as comprehensive but follow the same line of reasoning. Over time, we expect the NASDAQ and NYSE rules to converge since it is clearly the SEC's intent to ensure that companies do not choose their listing based on actual or perceived disparities in governance standards.

(For further information see the alert letters dated 7/01/03 and 12/23/03)

3. SEC

- The SEC issued final rules eliminating the use of paper forms and mandating the electronic filing of beneficial ownership reports for "insiders" under Section 16(a) of the Exchange Act. Additionally, companies with websites were required to provide access to these forms via their website by the end of the business day after filing by the insider

    — Section 16 applies to every person who is a beneficial owner of more than 10% of any class of equity security registered under Section 12 of the Exchange Act and each officer and director of the issuer

    — As required by the Sarbanes-Oxley Act, Section 16(a) was amended in August 2002 to require shorter filing deadlines for Forms 3, 4 and 5, i.e., generally within two business days

    — Reporting persons and companies were required to comply with the reporting rules and website posting requirements for reports filed on or after June 30, 2003

Implications: The effect of the electronic filing requirements is to achieve earlier public notification of insiders' transactions and wider public availability of information about those transactions.

(For further information see the alert letters dated 8/28/02 and 5/19/03)

4. IRS/Taxation

- On June 9, 2003, the IRS issued its proposed regulations relating to the treatment of incentive stock options ("ISOs") and options granted under employee stock purchase plans ("ESPPs") that update, reorganize, and replace the regulations under Internal Revenue Code Sections 421 through 424. Taxpayers may rely on these proposed regulations for options granted after June 9, 2003. The important features of the proposed regulations are:

    — ISOs may only be granted from a plan that states the maximum number of shares that may be granted for all stock-based awards under the plan

        -- Plans that allow shares purchased using option exercise proceeds to be added back to the share reserve pool will not be permitted to grant ISOs

due to the uncertainty in the number of shares that may be added back in the future

- ISOs assumed in a corporate transaction must be granted by the buyer from a plan that satisfies the ISO requirements or such ISOs will be deemed modified and lose their tax favorable status

- ISOs may be transferred to certain grantor trusts as long as the employee is the sole beneficial owner of the option while held in the trust under applicable law

- The proposed regulations now incorporate the current limitation that does not permit options on stock having a fair market value at grant of more than $100,000 to vest in any one year

Implications: Note that the above regulations are proposed regulations and may change after public comment. It is expected that the stipulation that plans should specify the maximum number of shares that may be awarded for each grant type will be dropped from the final regulations. It is also expected that it would be allowable for shares from option exercise proceeds to be added back to the pool. However, companies should be cognizant of the fact that ISOs granted after June 9, 2003 from plans that do not conform to the above regulations may be tarnished.

(For further information see the alert letter dated 7/16/03)

- On May 28, 2003, President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JAGTRRA). Some of the important tax changes instituted by this legislation are:

  - The top individual rate on adjusted net capital gains was reduced from 20% to 15%. The tax rate reduction applies to assets that are held for more than one year (short-term capital gains continue to be taxed at ordinary income tax rates)

  - Dividends received from domestic corporations or qualified foreign corporations[1] will generally be subject to the same tax rates as capital gains (i.e., the top individual rate of 15%)

Implications: The impact of the reduced tax rates on equity compensation is limited since stock price appreciation and dividend payments attributable to unvested equity compensation are generally subject to ordinary income tax until the compensation is vested. A possible impact may be if employees increase utilization of Section 83(b) elections[2], which would allow the reduced tax rates to apply to future stock price appreciation and dividend payments of unvested equity compensation. However, this is unlikely since these elections have certain

[1] Qualified foreign corporations include foreign corporations traded on U.S. securities markets using American Depository Receipts or corporations incorporated in a U.S. possession

[2] Section 83(b) elections accelerate the taxable event related to property subject to a substantial risk of forfeiture (e.g., unvested equity compensation).

shortcomings such as not receiving a tax credit if the compensation is ultimately forfeited and payment of the tax obligation earlier than necessary.

(For further information see the alert letter dated 7/02/03)

5. Other Governance Initiatives and Compensation Developments

- On July 8, 2003 Microsoft announced far-reaching changes to its equity compensation program:
  - Beginning in fiscal 2004, employees will receive grants of restricted stock units (without dividend equivalents) and/or performance stock in lieu of stock option grants
  - Employees holding underwater stock options had a one-time opportunity to transfer their options to JPMorgan Chase & Co. in exchange for cash. The offer only applied to options with exercise prices above $33. The cash offered was based on a Binomial valuation of the options that has a truncated term and lower volatility as inputs.

Implications: The Microsoft announcement had a material impact on the world of executive compensation due to its status as an icon of corporate America. It is the harbinger of a shift among many companies away from equity compensation programs based solely on stock options to programs based on a variety of equity compensation vehicles. The stock option transfer program offers companies a possible solution to low employee morale caused by underwater stock options. However, it has several disadvantages such as heavily discounted proceeds ultimately reaching employees, and substantial transaction costs to the company.

(For further information see the alert letters dated 7/28/03 and 10/31/03)

- In August of 2003 Richard C. Breeden, former Chairman of the SEC, released a report recommending changes to WorldCom's corporate practices in his capacity as corporate monitor to the company. The following were some of its most important recommendations with regard to executive compensation, operation of the compensation committee and Board compensation:
  - The Company should increase the proportion of cash and reduce the proportion of equity that is used in overall compensation
  - The Company should prohibit the use of large retention payments that are not tied to performance and are otherwise without ostensible purpose
  - The Company should limit the maximum severance that can be paid to any employee absent a shareholder vote
  - The Articles of Incorporation should establish an overall limit on compensation in any single year for any individual without a vote of shareholders

— The by-laws should require retention of not less than 75% of the net after-tax value of all equity awards to employees until at least six months following termination. Mandatory levels of stock ownership should also be set for management

— The Company should not enter into "evergreen" employment contracts or any employment agreement with a total duration of more than three years

— The Compensation Committee should have not less than three independent members, and compensation consultants should be retained by the Committee directly

— The report recommends substantial retainers for Compensation Committee membership/chairmanship and for service on the Board. Director compensation should be exclusively paid in cash

— Directors should be required to make purchases of common stock each year equal to at least 25% of cash compensation. This stock should be held for at least six months following termination

Implications: Several of the recommendations are of interest for possible adoption by companies in advancing "best practices" in Compensation Committee governance of executive compensation. However, several of the recommendations are extreme and may not see widespread acceptance. Mr. Breeden's stature has brought attention to this report but it remains to be seen if it has lasting impact.

(For further information see the alert letter dated 9/22/03)

- In late 2003 the National Association of Corporate Directors (NACD) released a Blue Ribbon Report on *Executive Compensation and the Role of the Compensation Committee*. Some of the best practices on executive pay recommended by the report are as follows:

  — Competitive precedent set by other companies should not drive the decision-making process

  — Companies should develop a formal compensation philosophy

  — Committee membership should be fully independent

  — Committee duties include developing and adopting a formal charter, establishing objectives and evaluating performance, and managing CEO succession planning

  — The Committee should engage the assistance of an independent compensation consultant that does no work for management

  — The Committee should have a self-evaluation process

— The report sets forth four fundamental principles to guide the decision making process in creating effective compensation systems – internal and external fairness, use of meaningful performance metrics to determine pay, required purchases of company stock by executives to ensure long-term shareholder value creation, and transparency in disclosure

Implications: We anticipate that the principles espoused by the Report will encourage more considerate and thoughtful decisions within compensation committees with regard to all aspects of the executive compensation process. However, some of the specific policies recommended in the Report may be rejected as administratively cumbersome, economically inefficient, or redundant with current regulatory requirements and established practices.

(For further information see the alert letter dated 1/07/04)

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Questions regarding the topics covered in this letter may be directed to the consultant(s) referenced at the end of the corresponding "alert" letters. General questions regarding this letter may be directed to DJ Shetty in our New York office at (212) 986-6330. Additional information regarding our firm and other executive compensation topics may be found on our website at www.fwcook.com.

Note: Full text of all alert letters as well as copies of other reports, speeches, etc., can be found at out website www.fwcook.com.

Referenced "Alert" Letters by Date

1) **August 28, 2002** – "SEC Finalizes Rules On Ownership Reports And Trading By Officers, Directors And Principal Security Holders"

2) **January 10, 2003** – "FASB Issues Final Standard on Amendments to Statement 123"

3) **May 19, 2003** – "SEC Finalizes Rules Concerning Section 16(a) Reports: Electronic Filing And Website Posting"

4) **June 23, 2003** – "FASB Makes Headway on Stock Compensation Project"

5) **July 1, 2003** – "NYSE Releases Final Shareholder Approval Requirements"

6) **July 3, 2003** – "Jobs and Growth Tax Relief Reconciliation Act of 2003"

7) **July 16, 2003** – "IRS Proposes New Regulations For Incentive Stock Options and Employee Stock Purchase Plans"

8) **July 28, 2003** – "A Retreat from Options: Microsoft's New Stock Compensation Program"

9) **September 18, 2003** – "FASB Delays Timetable on Stock Compensation Project But Project Derailment Still Not Likely"

10) **September 22, 2003** – "MCI Report Suggests New Standards in Executive Compensation Governance"

11) **October 31, 2003** – "Transferable Stock Options: Microsoft's Program"

12) **November 5, 2003** – "FASB Announces Planned Effective Date and Method of Transition for Stock Option Expensing Mandate And Reaches Further Convergence With IASB"

13) **December 23, 2003** – "NYSE Releases Guidance on Shareholder Approval Rules For Equity Compensation Plans"

14) **January 7, 2004** – "NACD Releases Blue Ribbon Report on Executive Compensation and the Role of the Compensation Committee"

Other Alert Letters Issued During the Year

January 16, 2004 – "ISS 2004 Policy Changes"

March 14, 2003 – "FASB Decides to Add Stock Compensation Project to Agenda *The End of Opinion 25*"

March 13, 2003 – "Year in Review (2002) – Navigating the Complexities of Executive Compensation Reforms"

May 2, 2003 – "Board of Director Compensation: A Changing Environment"

August 8, 2003 – "Valuation of Employee Stock Options: Summary of Views from FASB's Option Valuation Group"

August 20, 2003 – "European Commission Report – The Legal and Administrative Environment for Employee Stock Options in the EU"

December 8, 2003 – "The Business Roundtable Issues New Guiding Principles for Executive Compensation"