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2004 – The Year in Review
Executive Compensation Regulatory Framework Dramatically Altered

Executive compensation reform and regulation continued to be front-page news in 2004, with developments closely watched by the U.S (if not the entire global) business community. The passage of the Sarbanes-Oxley Act in 2002 opened the floodgates of executive-compensation reform, with a torrent of far-reaching actions in 2004, as well as 2003, leaving the regulatory landscape dramatically changed.

Foremost in 2004, the Financial Accounting Standards Board (FASB) finalized rules imposing the requirement that stock options be expensed. In December, after intense deliberations and attempted political road-blocking, FASB issued Financial Accounting Standards Statement 123(R), containing the final rules for "share-based payment" which will take effect in mid-2005. Reflecting the heightened political interest in executive compensation, Congress created a new section of the Internal Revenue Code (409A) with tax rules and penalties on "deferred compensation" not meeting certain requirements, as included in the American Jobs Creation Act of 2004. "Disclosure" was the key word in 2004 from the Securities and Exchange Commission (SEC) as it expanded the list of compensation items reportable on Form 8-K and shortened the filing time to four business days, while stepping up efforts for clearer and more comprehensive disclosure of executive compensation. Shareholder activism also continued to accelerate in 2004, with a sharp focus on executive compensation issues.

This summary highlights the major regulatory and technical developments in 2004 affecting the compensation of executives of U.S. corporations. The specifics of the developments are not included in this summary, but may be found in the related "alert" letters listed at the end of this summary, accessible via our website at www.fwcook.com. Broader implications and changes in practice that may flow from these developments are beyond the scope of this summary.

Accounting – *FASB Finalizes Stock Compensation Rules*

FASB's stock option expensing project provided a dose of drama and suspense rarely seen in the usually staid world of technical and regulatory underpinnings of compensation design and delivery. What was FASB going to do? Would Congress override FASB? When would changes take effect? The uncertainty and controversy surrounding the ultimate outcome, and potential impact on reported corporate earnings and pay packages of tens of millions of workers, made stock option accounting one of the top business issues of 2004.

It was a grueling year, but FASB completed its amendments to FAS 123 on schedule. Numerous meetings and deliberation were held throughout the year, with related updates issued periodically. Key dates and steps in the process during 2004 included the following:

- March 31 – Exposure Draft issued, laying out the new proposed standard
- June 30 – End of a "comment period" during which interested parties were invited to submit written comments on the Exposure Draft
- Late June – Public roundtable meetings held to discuss issues with invited constituents
- October 13 – FASB announces its decision to delay the effective date from December 15, 2004 to June 15, 2005
- December 16 – Final statement issued – Statement of Financial Accounting Standards No. 123 (revised 2004), generally referred to as "FAS 123(R)"

Running parallel (and counter) to FASB's efforts, an intense lobbying effort to derail the pending new standard was taking place in Congress. Despite warnings from Alan Greenspan and others on interfering with the regulatory process, the House of Representatives convincingly approved (312-111) legislation on July 20 delaying the implementation of the FASB proposal for at least one year pending completion of economic impact studies by the Commerce and Labor Departments and, as an interesting twist, also calling for the immediate expensing of options granted to a company's CEO and the next four most highly compensated executive officers. The legislation faced strong opposition in the Senate, however, and was not approved.

Before getting into the details of the provisions to FAS 123(R), a brief review of existing accounting principles is useful in understanding FAS 123(R) (and the related debate over its adoption).

- APB Opinion No. 25, *Accounting for Stock Issued to Employees* – is the long-standing accounting standard used today by most companies in expensing stock options and other forms of stock compensation. Under APB 25, the *"intrinsic value"* of stock options and other forms of stock compensation determines the amount of compensation expense. Under the intrinsic value method, expense generally is equal to the difference between the stock price on the date of grant and the price the employee pays for the stock. With a standard stock option, where the exercise price typically equals the stock price at grant, the intrinsic value is zero.
- FASB Statement No. 123, *Accounting for Stock-Based Compensation* – is the predecessor of FAS 123(R), and was adopted in 1995 after a decade-long review of stock option expensing by the FASB. Under FAS 123, the *"fair value"* at grant of stock options and other forms of stock compensation generally determines the amount of compensation expense. Under the fair value method, expense is based on an option pricing model (such as the Black-Scholes or binomial models) that considers, among other factors, stock price volatility and the expected option term. With a standard stock option, FAS 123 results in expense (unlike APB 25). Under current principles, companies can elect to use APB 25 or FAS 123 to account for stock

options and other forms of stock compensation, with the vast majority opting for APB 25. If APB 25 is used, pro-forma disclosures of the earnings impact under FAS 123 must be included in the footnotes to the financial statements.

Given the fundamentally different approach to valuing stock compensation under APB 25 and FAS 123, the number-one major change imposed by FAS 123(R) (and which has created the controversy) is that APB 25 can no longer be used after the effective date of FAS 123(R). An explicit expense will be required to be recognized in the income statement for stock options going forward, where it was optional in the past.

With that context, the basic method for determining the expense for share-based payments under FAS 123(R) is as follows:

- Equity awards to employees are generally accounted for at fair value (with the intrinsic value method repealed, except in limited situations)

- Fair value is measured and fixed at grant for stock-settled awards ("fixed" treatment), and at subsequent exercise or settlement for cash-settled awards ("variable" treatment)

- Fair value equals the underlying value of the stock for "full-value" awards such as restricted stock and performance shares, and will be estimated using an option-pricing model with traditional inputs for "appreciation" awards such as stock options and SARs

- Compensation cost equal to fair value will be recognized net-of-tax over the vesting or performance period only for awards that vest

- Subsequent modifications to outstanding awards result in incremental compensation cost if fair value is increased as a result of the modifications (thus, a value-for-value stock option "repricing" would not result in additional compensation cost)

Special considerations under FAS 123(R) include the following:

- Employee Stock Purchase Plans (ESPPs) generally will avoid compensation expense only if the purchase price is discounted by 5% or less, there is no look-back feature, and the plan is broad-based

- Each reload stock option will be treated as a new, separate grant and expensed accordingly

- Awards that vest based on a "market condition" (such as share price, total shareholder return, or total shareholder return relative to an index or peer group) will be valued at the time of grant, with no adjustment made to compensation cost even if the market condition is not satisfied and the award is forfeited

- For awards with standard service vesting or a "performance condition" not related to the company's relative or absolute share price or shareholder return, the fair value of the award will be estimated at the time of grant without consideration of the effect of the service or

performance conditions, and the expense will be "trued-up" based on the actual number of share that vest or are earned

- Nonpublic companies are subject to the same fair-value compensation-cost provisions as public companies, but may use the historical volatility of an appropriate industry sector if it is not practicable to estimate the expected volatility of its share price

FAS 123(R) becomes effective for public companies for annual and quarterly reporting periods beginning after June 15, 2005 (December 15, 2005 for small business issuers). For nonpublic companies, the new standard applies to fiscal years beginning after December 15, 2005.

In transitioning to the new standard, FAS 123(R) provides several alternatives, with a "modified prospective method" being the default position. Under this approach, FAS 123(R) will apply to all new grants after the effective date and the unvested portion of outstanding grants as of the effective date, which will be valued based on the assumptions and methods used at the time the grants were initially made (re-measurement is not permitted). Companies that have not previously adopted FAS 123 may, alternatively, elect to restate prior earnings under a "modified retrospective method."

The final statement varied in several aspects from the initial Exposure Draft, as revised by the FASB during its redeliberations in light of input and comments received, reflecting a shift back to the provisions of FAS 123 (the original statement):

- An initial preference for lattice-based option-pricing models, such as the binomial model, was eliminated from the final statement, thereby permitting the continued use of the Black-Scholes and other "closed-form" models

- The final statement permits the continued use of straight-line cost amortization for awards with graded (installment) vesting, in contrast to the Exposure Draft's "front-loaded" requirement to treat each installment as a separate grant, which would accelerate the recognition of expense

- In regard to transition methods, the "retrospective" alternative, absent in the Exposure Draft, was included as part of the final statement

- The treatment of income tax effects in the final statement reverted to the original approach in FAS 123, which continues to permit the use of prior excess tax benefits to offset any current tax benefit deficiency

- A 5% discount under ESPPs was included the final statement, while no discount was permitted in the Exposure Draft

As a final international note on the accounting front in 2004, FASB's efforts were coordinated, in the interest of global convergence of accounting standards, with a similar initiative of the International Accounting Standards Board (IASB).

IRS/Taxation – *New Rules and Possible Penalties on Deferred Compensation*

In 2004, a flurry of legislative activity was taken to impose new taxes and constraints on deferred compensation, with separate but similar bills being passed by the House and Senate. An early version of the legislation, the Jumpstart Our Business Strength Act ("JOBS"), was passed by the Senate on May 11, tightening the rules on deferred compensation and imposing potential penalties for noncompliance. The House of Representatives on June 17 passed the American Jobs Creation Act which, like JOBS, taxed deferred compensation on a current basis unless certain requirements were met. Congress ultimately agreed upon the American Jobs Creations Act of 2004, which was approved by the Senate on October 11 and signed into law by the President on October 22.

The Act is far-reaching and significantly changes the requirements that must be met by deferred compensation arrangements in order to avoid immediate taxation and potential penalties. The Act creates a new Section 409A of the Internal Revenue Code, under which a wide variety of compensation arrangements have been swept into the definition of "nonqualified deferred compensation," as indicated in the following table. IRS guidance in late December clarified that stock-settled SARs, with an exercise price not less than market price on the date of grant, will not be treated as deferred compensation subject to Section 409A.

Plans Subject to Section 409A	Plans Not Subject to Section 409A
• Discount stock options (exercise price less than market price at grant) • Restricted stock units and performance share units providing for deferral of payment after vesting • Deferred stock units • Stock appreciation rights (SARs) with a discount exercise price • Phantom stock • Employee stock purchase plans that do not satisfy Internal Revenue Code Section 423 • Supplemental retirement plans and excess retirement plans • Severance plans permitting elections between lump sum and installment payments • Severance agreements and plans if payments are not made in full within 75 days after the end of the year employment terminates	• Stock options on employer stock with an exercise price at least equal to fair market value on grant date • Stock-settled SARs with no discount • Restricted stock (real shares) • Performance shares (if shares are issued at grant subject to forfeiture if performance conditions are not met) • Employee stock purchase plans satisfying Internal Revenue Code Section 423 • Tax-qualified retirement plans under Internal Revenue Code Sections 401(a), 403(a) and 403(b), and eligible deferred compensation plans of governmental and tax-exempt employers under IRC Section 457(b)

Compensation deferred under a nonqualified deferred compensation plan will be subject to current tax unless it is subject to a substantial risk of forfeiture, or meets the following requirements of Section 409A:

- The initial election to defer (including form of payment) must be made before the start of the year in which the compensation is earned, except for "performance-based" compensation, in which case the deferral election can be made up to six months before the end of the performance period

- A subsequent election to further defer payment (or change the form of payment) must be made at least 12 months prior to the date the deferred compensation would have otherwise been received, and extend payment at least five years beyond the original payment date (except in the case of certain permitted events)

- Distributions may be made only upon separation from service (with a six-month delay for certain "key employees" of public companies), at a specified time or under a fixed schedule, upon disability (as defined in Section 409A) or death, a change in control (as provided in IRS guidance), and the occurrence of an unforeseeable emergency (as defined in Section 409A)

- No acceleration of payments is permitted, except as may be provided in IRS regulations

Failure to comply with the Act makes vested nonqualified deferred compensation taxable on a current basis. In addition, any amount included in income will be subject to an increased tax equal to 20% of the original deferral and any earnings, and interest at the underpayment rate plus 1% on the tax that should have been paid on the original deferral and any related earnings.

The new rules apply to amounts deferred after December 31, 2004. The IRS issued preliminary guidance on the new rules on December 20, as revised on January 5, 2005. Under this guidance, various dates have been established for taking action in compliance with the new rules. See our recent "alert" letter of February 28, 2005, "Action Items in Response to IRS Guidance on Deferred Compensation Elections, Amendments, Cancellations and Termination in 2005" for details.

SEC – *Continued Focus on Executive Compensation Disclosure*

Executive compensation remained on the SEC's front burner in 2004, with increased clarity and transparency in the disclosure of executive compensation a key theme.

As mandated by Sarbanes-Oxley, the SEC finalized rules expanding Form 8-K disclosure and acceleration of its filing date, which became effective on August 23. In addition to other items, the new rules require the prompt reporting of changes in top management and directors, as well as the adoption or amendment of employment contracts and other material executive compensation or benefits arrangements. Under the new guidelines, a Form 8-K must be filed within four business days of the reportable event. Historically, most events did not require a Form 8-K filing, with delayed filing in a periodic report (Form 10-Q or 10-K) being an acceptable practice. The SEC made a concerted effort to deliver more information to the investment community in less time, consistent with the requirements of Sarbanes-Oxley (while unwittingly coining a new verb, as in "Do we need to *'8-K'* that?").

Of the SEC's nine categories of reportable items requiring expanded 8-K disclosure, Sections 1 and 5 are the most relevant to executive compensation:

- Section 1 deals with entering into and terminating material definitive agreements, which includes employment agreements, compensation and retirement plans and agreements, and deferred compensation plans covering executive officers and directors; while information about plan changes and agreements must be reported in the Form 8-K filing, actual copies of the plan or agreement do not need to be filed as exhibits until the next 10-Q or 10-K

- Section 5 covers corporate governance and management, with disclosure requirements in regard to the appointment, termination, or resignation of directors and certain officers (which, in the case of directors, includes refusal to stand for re-election)

The SEC's Current Report on Form 8-K Frequently Asked Questions, published on November 23, provided additional guidance on the rules, although questions remain in practice on the extent to which disclosure is required including whether material salary increases of proxy officers must be disclosed.

In addition to rule-making, the SEC staff made public remarks on the need for better disclosure of executive compensation. Of particular note was the speech Alan Beller, Director of the Division of Corporate Finance at the SEC, delivered to the National Association of Stock Plan Professionals ("NASPP") in October. While his remarks addressed primarily the SEC's traditional focus on the disclosure of executive compensation and compliance with the proxy statement/10-K disclosure rules in Regulation S-K Item 402, he also shared his views on certain executive compensation practices (including the need to better align pay with performance, and what he called the "Lake Wobegon effect, where everyone is [paid] above average").

Clarity, transparency, and completeness of disclosure were the key themes of Mr. Beller's address. In particular, he lamented the "existence of too much uninformative disclosure" and "opaque or unhelpful disclosure," rather than disclosure that "seeks to inform." He also made clear that all compensation must be disclosed, even if not specifically required under the SEC rules. But what was not clearly said, although implied by Mr. Beller, was that compensation must be disclosed even if the SEC rules specifically say that it does not have to disclosed (for example, the SEC rules provide that the amount of dividends paid on restricted stock do not have to be disclosed so long as they are at the same rate as for other shareholders).

Additionally, Mr. Beller expressed his fear that companies are routinely omitting items from their disclosure that should be included. Most of these items involve perks that have been creatively categorized as business expenses or for security purposes. Indicating that the SEC is serious about this issue, Mr. Beller referenced a proceeding against General Electric Company, announced on September 23, related to GE's failure to fully describe the benefits it was providing to their former Chairman and CEO Jack Welch.

In closing, Mr. Beller indicated that changes in the SEC's rules on executive compensation may be in store, as a group in the Division of Corporation Finance is in the early stages of developing possible recommendations to the SEC. Areas for possible review include more detailed disclosure of perks, retirement benefits and deferred compensation, total compensation, and director compensation.

Shareholder Activism – *Continuing Focus on Executive Compensation*

Executive compensation, according to noted attorney Martin Lipton, "is today's most high-profile corporate issue and a major focus of shareholder activism." Given the importance of executive compensation in effective corporate governance, 2004 saw the continuing expansion in the types and influence of shareholder advocacy groups, which have evolved far beyond the corporate "gadflies" of the past and now fall into three main categories: large pension funds such as CalPERS and TIAA-CREF, shareholder advisory firms like Institutional Shareholder Services (ISS) and Glass, Lewis & Co., and organized labor unions like the AFL-CIO. And apart from shareholder groups, other organizations working directly with corporations, such as the Conference Board and National Association of Corporate Directors, continued to gain prominence in 2004 as advocates for improved governance of executive compensation.

Key issues of concern among shareholder groups in regard to executive compensation in 2004 and into 2005 were discussed by a panel of institutional shareholders (the Ohio Public Employees Retirement System and TIAA-CREF) and shareholder advisory firms (ISS and Glass, Lewis) at a Conference Board seminar co-sponsored by Frederic W. Cook & Co. in Chicago in January 2005. Key issues included stock plan dilution and excessive use of stock options (including "evergreen" plans), a general disconnect between pay and performance, excessive severance and change-in-control packages, and the need for better communications with shareholders including (and echoing Alan Beller's comments) clearer and more comprehensive disclosure in proxy statements, particularly in regard to supplemental pension and deferred compensation arrangements.

ISS's voting guidelines and policies in regard to executive compensation, as revised and updated in 2004, illustrate the types of approaches used by shareholder groups that, for ease of explanation, can be thought of as being of two basic types: equity compensation plans and other types of compensation proposals.

In the case of equity compensation plans, ISS uses a multi-prong test in developing its voting recommendation which reflects key concerns of shareholders, including relative plan cost, stock option repricing, CEO pay relative to performance, and excessive share usage. In general, ISS will recommend an "against" vote for any compensation plan if any of four factors exist:

- The cost of the plan (as measured under ISS's "shareholder value transfer" and "voting power dilution" methodologies) exceeds the ISS's "allowable cap" (as determined based on company size and industry grouping)

- Option repricing is specifically permitted in the plan

- Total shareholder return for the past one- and three-year periods has been negative and, if so, CEO total pay increased in the last reported year (which, if met, is subject to an additional and complicated analysis that could lead to a possible "for" recommendation for the plan or, conversely, a "withhold" recommendation for compensation committee members up for reelection)

- Three-year average "burn rate" (run rate) exceeds the industry mean plus one standard deviation

In regard to other compensation-related proposals, ISS announced the following positions in 2004:

- ISS previously supported shareholder proposals mandating stock option holding periods but, going forward, will take a case-by-case approach and evaluate each company's current executive stock ownership as well as ownership guidelines

- Proposals advocating the use of performance-based awards will be supported by ISS unless the proposal is considered overly restrictive or the company's practice is to grant "substantial" performance-based awards to its five-highest paid executives

- A substantial change from previous policy is that ISS will now support proposals for supplemental pensions to be shareholder approved, unless the benefits do not exceed what is offered under company-wide plans

- Beginning in 2004, ISS will support all shareholder proposals requiring companies to exclude the impact of pension plan income when determining executive bonuses and other performance-base compensation

- ISS also indicated that it will determine its recommendations on mergers and acquisition on a case-by-case basis, with potential change-in-control payments to executives being one consideration

ISS's policies are only one illustration of the approach shareholder advisory and institutional shareholders have taken in regard to voting on executive compensation matters. Although generally based on common principles and concerns, policies and tactics on executive compensation governance and reform vary widely among shareholder groups and may include "withhold" campaigns targeting specific issues. For example, CalPERS has developed a quantitative model of CEO pay and company performance for use in guiding its voting decisions on equity plans and election of compensation committee members. Unlike the ISS model which focuses exclusively on year-over-year change in CEO pay in relation to the company's absolute total shareholder return (TSR), the CalPERS model compares CEO pay and company performance to peers. Additionally, CalPERS will develop a list of what it considers "abusive or exemplary" compensation practices, and will publicly identify each year those 10-15 companies having the worst pay-performance scores, and those who have, in their opinion, exemplary pay practices.

<u>Other Related Developments</u>

Although not part of the "regulatory" framework of executive compensation per se, the judicial system is having an increasingly significant impact on executive compensation, particularly in regard to the process by which executive compensation decisions are made. In Delaware, for example, traditional doctrines have been reshaped by recent cases (including *Disney*) with basically an over-arching "good faith" test having been added to the other two prongs of the

business judgment rule – the duty of loyalty and the duty of care. The Webb report to the NYSE on the investigation relating to Mr. Grasso's compensation, completed in December 2003 and made public in February 2005, concluded that Mr. Grasso received unreasonable levels of compensation and benefits. It will be interesting to watch how the traditional application of case law in the courts interacts with the increased legislative activity regarding executive compensation.

Looking Ahead

What's ahead on the regulatory front for 2005? The bulk of activity is expected to focus on elaboration and clarification of major actions taken in 2004, with guidance expected from FASB and the SEC on the new accounting rules, and more IRS guidance on Section 409A. Pressure from the SEC, as indicated by Alan Beller's comments last fall, and shareholder activism on compensation matters show no signs of decline. But we are not expecting the extent or breadth of changes seen in 2004.

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This letter was prepared by Edward Graskamp and Richard Zubek in our Chicago office. General questions may be directed to them at (312) 332-0910. Questions regarding specific topics covered in this letter may be addressed directly to the consultant(s) referenced at the end of the related "alert" letters listed below, which may found, along with additional information on our firm and other executive compensation topics, on our website at www.fwcook.com.

List of 2004 "Alert" Letters by Topic and Date

Accounting

12/20/04 – "FASB Issues Final Statement on Accounting for Share-Based Payment"

10/20/04 – "FASB Decides on Effective Date for Option Expensing "

09/03/04 – "FASB Makes Progress On Stock Compensation Redeliberations"

07/22/04 – "Update on Close of FASB's Public Comment Period"

05/28/04 – "Lattice-Based Stock Option Valuation Models"

05/10/04 – "FWC Response to FASB's Invitation to Comment on Exposure Draft"

04/13/04 – "FASB Issues Exposure Draft on Share-Based Payment"

02/26/04 – "IASB Issues Final Standard on Share-Based Payment"

IRS/Taxation

12/22/04 – "IRS Guidance on Provisions of American Jobs Creations Act of 2004 – Stock-Settled SARs of Public Companies Permissible; Transition Rules Provided"

12/02/04 – "Provisions Affecting Deferred Compensation in the American Jobs Creation Act of 2004"

10/12/04 – “American Jobs Creation Act Approved by Congress”

06/28/04 – “UPDATE: Provisions Affecting Deferred Compensation in the American Jobs Creation Act of 2004”

05/29/04 – “JOBS Provisions Affecting Deferred Compensation”

SEC

08/19/04 – “Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date”

Corporate Governance

12/17/04 – “ISS 2005 Policy Changes”

01/16/04 – “ISS 2004 Policy Changes”

01/07/04 – “NACD Releases Blue Ribbon Report on Executive Compensation and Role of the Compensation Committee”

General

08/12/04 – “Regulatory Update – (Accounting/Tax Issues)”

3/12/04 – “Executive Compensation Year in Review (2003)”