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2005 – The Year in Review
Working Toward Clarity in Executive Compensation

Whereas recent years brought sweeping framework changes such as stock option expensing and deferred compensation reform, legislative and regulatory developments in 2005 primarily sought to clarify and finalize these rules as companies worked to transition their programs and practices to ensure compliance. New proxy disclosure rules, proposed by the SEC in early 2006, are likely to take center stage this year.

Foremost in 2005, FASB provided additional guidance regarding issues pertaining to the mandatory expensing of stock options. First, FASB delayed the effective date for stock option expensing for public companies to the first quarter of the first fiscal year beginning on or after June 15, 2005. Additionally, FASB provided direction on models and assumptions to be used for the purpose of stock option valuation as well as clarifying terms of the "grant date" as noted under FAS Statement 123(R). Elsewhere in the executive compensation arena, additional guidance and transition relief rules were provided for the new deferred compensation rules in Section 409A of the Internal Revenue Code. On the shareholder front, ISS announced policy changes for 2006 that impact their proxy voting recommendations for directors, compensation committee members, and equity plans. In the most significant development in the past year (which actually occurred in early 2006), the SEC proposed new rules that would dramatically alter the content and format of executive compensation proxy disclosures.

This summary highlights the major regulatory and technical developments in 2005 affecting executive compensation at U.S. corporations.

This document is intended to provide only the highlights and key issues associated with regulatory and legislative developments in executive compensation in 2005. 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 Web site at www.fwcook.com. The information in this alert letter is arranged under the following four categories:

1. FAS Statement 123(R) Guidance
2. Deferred Compensation Guidance
3. 2006 Institutional Shareholder Services ("ISS") Policy Changes
4. SEC Proposal for New Proxy Disclosure

1. FAS Statement 123(R) Guidance

SEC Sets New Effective Date for Statement FAS 123(R):
On April 14, 2005, the SEC voted to delay FAS Statement 123(R), which mandates the expensing of stock options. Public companies must now comply with Statement 123(R) as of the first quarter of the first fiscal year beginning after the effective date originally prescribed in Statement 123(R). Accordingly, calendar-year public companies must begin complying with Statement 123(R) in the first quarter beginning in 2006, rather than the third quarter of 2005 as prescribed under the original proposal. The following chart summarizes the new effective dates and transition methods for Statement 123(R):

	Required Effective Date (Periods Beginning After)(1)	**First Applicable Reporting Period**		**Required Transition Method**	**Optional Transition Method (Modified Retrospective)**	
		As Originally Required by Statement 123(R)	**As Revised by the SEC**		**All Periods(2)**	**Year of Adoption(3)**
Public Companies	6/15/05	*First quarter* beginning after effective date	First quarter of *first fiscal year* beginning after effective date	Modified Prospective	Yes	Yes
Small Business Issuers(4)	12/15/05	*First quarter* beginning after effective date	First quarter of *first fiscal year* beginning after effective date	Modified Prospective	Yes	Yes
Nonpublic Companies - Fair Value(5)	12/15/05	First quarter of *first fiscal year* beginning after effective date	First quarter of *first fiscal year* beginning after effective date	Modified Prospective	Yes	Not Applicable
Nonpublic Companies - Minimum Value(5)	12/15/05	First quarter of *first fiscal year* beginning after effective date	First quarter of *first fiscal year* beginning after effective date	Prospective	Not Applicable	Not Applicable

(1) Early adoption of Statement 123(R) is encouraged for quarterly or annual financial statements that are not issued before the required effective date
(2) Modified retrospective application to all prior years beginning after the original December 15, 1994 effective date of Statement 123
(3) Modified retrospective application only for the annual period in which Statement 123(R) is initially adopted (for early adopters)
(4) Generally, a public company with revenues of less than $25 million
(5) Nonpublic company that previously adopted the "fair value" or "minimum value" provisions of Statement 123 for recognition or pro forma footnote disclosures

SEC and FASB Guidance on Stock Option Valuation:
In connection with Statement 123(R), which requires companies to expense stock options, the SEC provided additional guidance (in a March 29, 2005, Staff Accounting Bulletin (No. 107)) regarding stock option valuation. This section contains the highlights of this guidance:

- Model Choice - The guidance confirmed that companies may choose any valid option pricing model so long as it is:

  1. Consistent with the fair value measurement objective,
  2. Based on established principles of financial economic theory, and
  3. Reflective of all substantive characteristics of the award.

  Companies are permitted to use different models for awards with different characteristics and may change models infrequently without it being considered a change in accounting principle.

- Expected Option Term - Companies may use historical exercise behavior to estimate the expected term of stock options. For those companies that do not have enough exercise history, the SEC recommended that companies set the expected term equal to the average of the vesting period and the original contractual term until the company has enough exercise history to create an expected term based on experience.

  The guidance clarified that companies may not consider additional term reductions for nonhedgability, nontransferability, or forfeitures, and that the option term cannot be shorter than the vesting period. Fair value estimates and assumptions made in good faith will not be subsequently challenged.

- Volatility - The SEC believes that companies with actively traded options should consider using implied volatility, particularly in cases where there is enough volume, trading history, and a synchronization of option terms. Companies using historical volatility should do so on an unweighted basis for a period equal to or longer than the expected term for closed-form models and the contractual term for lattice models.

- Disclosure - The guidance also recommends enhanced disclosure of equity compensation, particularly during the adoption of Statement 123(R). Included in the list of items that should be addressed in such disclosure are the transition method and its expected impact on financial statements, the accounting method used prior to adoption, the discussion of award modifications made prior to the effective date, and any changes in valuation methodologies and/or assumptions.

- Accelerated Vesting of Stock Options - The SEC and FASB confirmed that companies may accelerate vesting of stock options before the stock option expensing effective date in order to avoid future expense; companies doing this must provide disclosure of such modifications and the rationale for doing so.

Implications: The guidance regarding stock option valuation is timely as companies transition into the option-expensing environment and begin recognizing potentially significant expense on their income statements. A company's choice of valuation model and the accompanying assumptions can have a large impact on the underlying expense. Understanding the company's latitude of discretion with respect to these issues is crucial to setting appropriate valuation assumptions for future stock option grants.

Acceleration of Compensation Cost for Retirement-Eligible Employees:
On March 9, 2005, our firm authored an alert letter explaining a provision of Statement 123(R) that received little, if any, attention even though it may materially impact many companies. Specifically, if an employee who receives an equity award is retirement eligible, and the terms of the award are that any nonvested portion of the grant would accelerate or continue to vest at retirement, grant date compensation cost must immediately be recognized at grant, not accrued over the vesting period.

Note that typical accounting practices accrued the cost of equity awards over the vesting period regardless of retirement eligibility, and recognized any remaining unrecognized cost only upon actual retirement. Although the SEC has reportedly grandfathered any erroneous accounting treatment of such equity awards granted prior to FAS 123(R) adoption (in order to prevent widespread restatements), once a company begins accounting under FAS 123(R), equity awards must be appropriately expensed as described in the previous paragraph.

Implications: The accelerated compensation cost for retirement-eligible employees may have a significant financial impact on the company. Depending on the magnitude of this expense and the reason for the award (e.g., for past performance or expected contribution), companies may need to review the terms of equity awards to determine whether changes are necessary.

Grant Date Communication Relief:
On October 18, 2005, the FASB approved FAS 123(R)-2, which established the "grant date" as the relevant Board/Committee approval date provided that employees are not able to negotiate the key terms and conditions of the award and that such terms and conditions are communicated to employees within a relatively short time period following Board/Committee approval. This reversed an earlier view that the grant date cannot occur until the terms and conditions of the award are communicated to employees.

Implications: While this reversal allows many companies to continue with their existing grant practices, it serves as notice that communication of grants to employees must follow the approval date in a timely fashion.

2. Deferred Compensation Guidance

The American Jobs Creation Act, signed into law by the President in October 2004, created new Section 409A of the Internal Revenue Code that greatly expanded the definition of "nonqualified deferred compensation arrangements." This development has far-reaching implications and will require compliance action by many, if not most, companies.

The details and implications of Section 409A are discussed in our October 12, December 2, and December 22, 2004, alert letters. Summarized below are the key requirements of deferred compensation plans and the additional Section 409A guidance provided by the IRS throughout 2005 regarding transition rules/deadlines, treatment of certain equity award types, and other related guidance.

Key Requirements of Deferred Compensation Plans:
The key requirements for compensation deferred under a nonqualified deferred compensation plan are listed below:

- Initial deferral elections must be made during the calendar year prior to the year in which compensation is earned or within 30 days after initial participation in the deferred compensation plan.

- Initial deferral elections for performance-based bonus compensation can be made up to six months prior to the end of the performance period.

- Subsequent elections regarding the amount deferred or form of payment may not be effective for at least 12 months and must result in a delay of payment for at least five years (except for death, disability, unforeseeable emergency or change in control).

- Deferred compensation plans must allow for distribution only under the following circumstances:

  1. Separation of service (six-month payment delay for "key employees")
  2. Specified time or pertaining to a fixed schedule specified as of the date of the deferral
  3. Disability (as defined in Section 409A) or death
  4 Change in control (as provided in guidance issued by IRS)
  5. Unforeseeable emergency

Transition Relief Deadlines:
In early 2005, the IRS issued Notice 2005-1, which provided guidance regarding the transition rules for nonqualified deferred compensation plans subject to Section 409A. Later in 2005, new guidance was issued in the form of Proposed Regulations that extended the transition relief in certain instances. The table on the following page summarizes key dates and deadlines based on the most recent transition relief guidance provided by the IRS (see the alert letter dated November 3, 2005, for more detailed information on each of these categories):

• Initial Deferral Elections for 2006 Services — Calendar year employer, not performance-based — Calendar year employer, performance-based — Fiscal year employer, not performance-based — Fiscal year employer, performance-based	 12/31/05 6/30/06 Prior to beginning of fiscal year Six months prior to end of fiscal year
• New Payment Elections — Amounts payable in 2006 — Amounts payable after 2006	 12/31/05 12/31/06
• Cancellation of deferrals and termination of plan participation	12/31/05
• Exercise of discount stock options and SARs (if not amended or replaced)	12/31/05
• Amendments to terminate grandfathered plans and arrangements	12/31/05
• Replacement of discount stock options and SARs — Payment of cash or vested stock (or property) included — No payment or payment subject to vesting	 12/31/05 12/31/06
• Amendments to comply with Section 409A — 2005 new payment elections, cancellation of deferrals, termination of plan participation, and March 15 initial deferral elections — Other amendments to comply with Section 409A	 12/31/05 12/31/06
• Payments controlled by elections under tax-qualified retirement plans	12/31/06

Stock Appreciation Rights (SARs):
Reversing earlier guidance limiting the exemption to stock-settled SARs, the IRS issued new guidance stating that SARs would not be treated as deferred compensation regardless of how the SAR is settled (cash vs. stock), as long as the SAR is issued at an exercise price equal to or greater than fair market value on the date of grant.

Dividends:
Stock options and/or SARs will be treated as deferred compensation if, upon exercise, the participant receives all or part of dividends declared or paid from the period between the grant date and the exercise date (analogous to discount stock options).

Severance Compensation:
Separation pay agreements that meet the following two conditions will be exempt from Section 409A:

1. Total payments do not exceed two times the employee's annual compensation for the calendar year prior to separation or, if lower, two times the annual limit on compensation that may be taken into account under tax-qualified retirement plans for that calendar year (the 2006 annual limit is $220,000); and

2. All payments are made by the end of the second calendar year following the calendar year in which the employee separates from service.

Key Employee Determination:
Section 409A requires that payments to key employees of public companies made upon separation from service must be delayed for at least six months following separation. Determination of key employees is made by applying the rules in IRC Section 416 to the 12-month period ending on the "identification date" selected by the employer.

Implications: At this point, most companies have reviewed all outstanding plans and agreements to determine those impacted by Section 409A. Once identified, impacted plans and agreements must be amended and modified (if necessary) by the appropriate deadlines (some of which have already passed) in order to be compliant with the new rules. Deferred compensation arrangements that do not meet the requirements of Section 409A will subject participants to costly additional taxes and corresponding interest payments.

3. 2006 ISS Policy Changes

On November 17, 2005, Institutional Shareholder Services ("ISS") released changes to its proxy voting policies for 2006. The information below summarizes these major changes:

Director Performance Test:
ISS announced it may decide to withhold votes for directors of the identified worst performing companies in each of ISS' 24 industry groups. The identification of the worst performing companies within each industry group will be based on a weighted TSR calculation. Decisions to withhold votes for such directors will be made in consideration of performance improvement in the current year, changes in management or board composition, recent transactions at the company, overall governance practices, and financial health of the company.

Treatment of Transferable Stock Options:
ISS determined that it will support new equity plans that permit transferable options as long as the plan cost (assuming a zero forfeiture rate for the TSO portion of shares) remains under the allowable cap and the appropriate disclosure of the ongoing transfer program is satisfied. If one-time transfers (e.g., the Microsoft option transfers of underwater options) are not submitted to shareholders for approval, ISS will recommend withholding votes from compensation committee members.

Note that this only relates to stock options transferred to third-parties for value (e.g., financial institutions); more traditional transfers, such as those to family members and estates, are outside the scope of this policy.

Elimination of Voting Power Dilution in Total Cost Calculation:
ISS will now calculate the cost of an equity plan proposal based solely on the plan's shareholder value transfer (SVT). Before this change, SVT was weighted 95% in the calculation of the plan's cost and the remaining 5% weighting was for the voting power dilution impact of current overhang and new shares being requested.

Dividend Equivalent Rights:
Recognizing that dividend equivalent rights increase the value of equity awards, ISS will begin accounting for them by applying a 0% dividend yield in its cost model if dividend equivalent rights are authorized.

Poor Compensation Practices:
ISS will withhold votes for compensation committee members and may recommend against equity proposals for those companies exhibiting substandard compensation practices including, but not limited to, egregious employment contracts, large bonus payouts without justified performance, internal pay disparity, and excessive perks.

Burn Rate Override Changes:
ISS relaxed its burn rate override policy for 2006, declaring that it will support equity plan proposals for companies that publicly commit to a 3-year average burn rate within one standard deviation of its industry group's mean. In 2005, ISS' burn rate override exemption required that companies commit publicly to a 3-year average burn rate equal to its industry group's mean (please review the alert letter dated November 29, 2005, for the 2006 Burn Rate Table).

Implications: For companies with significant shareholders that follow ISS' voting recommendations, an in-depth understanding of ISS' current cost modeling and voting policies is crucial to ensuring ISS' support.

4. SEC Proposal for New Proxy Disclosure

The SEC issued proposed new proxy disclosure rules on January 27, 2006, which contained major changes to executive compensation proxy disclosure that are likely to be effective for the 2007 proxy season. Although this is a 2006 development, the impact for shareholders and companies is so far-reaching that we have included a brief summary in our 2005 review (please review the alert letter dated February 1, 2006, for more detail).

Compensation Discussion and Analysis Section:
A new Compensation Discussion and Analysis section would replace the Compensation Committee Report and Performance Graph. The section would discuss all compensation awarded to, earned by, or paid to the Named Executive Officers (NEOs) as well as a description of the various elements of compensation, their objective in the program, and how the Committee determines the amount of each element. This section would be treated as "filed" with the SEC and would thus be subject to the liability provisions of the securities laws.

Summary Compensation Table Changes:
The major changes to the Summary Compensation Table under the proposed rules are reported below:

- Total Compensation Column – this new column would represent the sum of all other columns in the table.

- Salary and Bonus Columns – any deferred amounts must be footnoted as opposed to only voluntarily deferred amounts under the current rules.

- Equity Award Columns – fair value of all stock options and SARs granted would be shown. The current valuation alternative of showing gains at 5% and 10% per year would be eliminated. The dollar value of full-value stock awards, including those which are performance based, would be shown in a stock awards column. Earnings on all outstanding awards would be included in these columns (e.g., dividends).

- Non-Stock Incentive Plan Compensation Column – this new column would replace the "LTIP Payout" column and would show the dollar value of amounts earned during the year under incentive plans (i.e., plans not based on stock price), regardless of when the actual payment is made.

- All Other Compensation Column – this new column would expand and combine the current "other annual compensation" and "all other compensation" columns and would include, but is not limited to, perquisites with an aggregate compensation amount greater than or equal to $10,000, pension plan accruals, deferred compensation earnings, severance payments, dollar value of insurance premiums paid, tax reimbursements, and "gross ups."

Additional New Tables:
In addition to the changes to the Summary Compensation Table described above, the following new tables would be required under the proposed rules:

- Grants of Performance Awards – this table would illustrate the details of performance-based awards (defined as containing a "performance condition" or "market condition" in FAS 123(R)).

- Grants of All Other Equity Awards – this table would illustrate the details of nonperformance-based equity awards such as conventional stock options and time-based restricted stock.

- Outstanding Equity Awards Table – this table would illustrate the details of all outstanding equity awards held by NEOs.

- Amounts Realized Equity Table – this table would illustrate the amounts realized from equity awards including amounts realized from exercising stock options, vested restricted stock, etc., along with a comparison to the grant date fair value previously reported in the Summary Compensation Table.

- Retirement Benefits Table – this table would illustrate the annual retirement benefits under qualified and nonqualified plans as well as details such as years of service, the plan's normal/early retirement ages, and estimated annual benefits at normal/early retirement.

- Deferred Compensation Table – this table would contain information relating to nonqualified defined contribution retirement plans and other deferred compensation plans, including officer/company contributions, earnings, withdrawals and aggregate balances for each NEO.

- Director Compensation Table – this table would show each director's compensation for the prior year and would be analogous to the Summary Compensation Table for NEOs. This table would include all of the cash, equity, and other compensation (including the cost of charitable donation programs) for each director and would include a total compensation column.

Other Disclosure Changes:

- Named Executive Officer Definition – under the proposed rules, the NEOs would be the principal executive officer, the principal financial officer and the three other highest-paid executive officers as determined by total compensation (rather than the sum of salary plus bonus, which is currently used to define highest-paid NEOs). In addition, narrative disclosure of total compensation for the last year and a description of the job positions (not names) would be required for up to three employees who were not executive officers during that year if the employee's compensation was higher than any of the NEOs.

- Termination and Change in Control Plans – the proposed rules would require a narrative disclosure of any and all contracts or arrangements that provide for payments to NEOs upon termination of employment, change in responsibilities or a change in control of the company. This narrative must include the circumstance that would trigger payments, estimated payments and benefits, and the factors used to determine such payments.

Implications: The intent of these new proxy disclosure rules is to increase the transparency of executive compensation to shareholders. It is too early to predict how the enhanced disclosure of executive pay will, if at all, impact overall compensation levels and/or the types of vehicles used to deliver compensation. Even though the proposals may be revised prior to final adoption, companies should become familiar with the proposed rules to facilitate likely implementation in 2007.

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This letter was prepared by Claude Johnston and Eric Winikoff in our New York office. General questions may be directed to them at (212) 986-6330. 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 be found along with additional information on our firm and other executive compensation topics, on our Web site at www.fwcook.com.

List of 2005 "Alert" Letters by Date and Topic

11/29/05 – "ISS 2006 Policy Changes"

11/03/05 – "Year End Action on Deferred Compensation"

10/07/05 – "Heads-Up on Deferred Compensation Guidance"

09/16/05 – "FASB Provides Relief on Grant-Date Communication Issue"

04/29/05 – "Summary of FASB Statement 123(R)"

04/15/05 – "SEC Delays Effective Date for Statement 123(R)"

04/04/05 – "SEC Staff Releases Guidance on Option Valuation Under Statement 123(R)"

03/22/05 – "2004 – The Year in Review: Executive Compensation Regulatory Framework Dramatically Altered"

03/09/05 – "FAS 123(R) Requires Acceleration of Equity Compensation Cost for Retirement-Eligible Employees"

02/28/05 – "Action Items in Response to IRS Guidance on Deferred Compensation"