Frederic W. Cook & Co., Inc.

New York • Chicago • Los Angeles

September 22, 2003

MCI REPORT SUGGESTS NEW STANDARDS IN EXECUTIVE COMPENSATION GOVERNANCE

The SEC filed a fraud complaint against WorldCom in 2002 in response to accusations of accounting fraud and executive malfeasance under the former CEO, Mr. Bernard Ebbers. The court hearing the complaint appointed a corporate monitor, Richard C. Breeden, former Chairman of the SEC, to investigate corporate practices at WorldCom and to issue a report of recommendations. As part of the court settlement, WorldCom (to be renamed MCI upon emergence from bankruptcy) was required to adopt all of Mr. Breeden's recommendations, or to obtain an exemption from the court for any recommendation it believed it could not accept.

WorldCom now has an entirely new Board and management team. The new Board and CEO (Mr. Michael Capellas) unanimously agreed to adopt all of Mr. Breeden's recommendations on August 19th, and the report was made public on August 26th.

The Breeden Report has 10 sections containing 78 recommendations dealing with board governance. While the report and recommendations are directed specifically at WorldCom (MCI), they are expected to have broad applicability to the U.S. business community at large. Several recommendations are highly controversial and are not likely to find general favor – namely 10-year term limits for directors, separating the Chairman and CEO positions, changing accounting firms every 10 years, and a prohibition against stock options. However, several others are useful to consider by boards that wish to take leadership positions in best practices in corporate governance.

Three of the 10 sections are of particular interest to our readers – Executive Compensation, the Compensation Committee, and Board Compensation. The remainder of this letter describes the 23 recommendations contained in these three sections, and gives our commentary.

EXECUTIVE COMPENSATION

4.01 Greater Reliance on Cash Compensation

The Company should increase the proportion of cash (either base compensation or cash bonuses) that is used in overall compensation and reduce – though not eliminate – the proportion of equity used in compensation. The Compensation Committee should seek to develop a compensation program that relies primarily on cash while delivering competitive levels of overall compensation to executives. All compensation programs should have linkages to serious corporate performance measures.

FWC Comment: *The report text leading up to this recommendation advocates that cash compensation make up "[N]ot less than 50%, and ideally 60-75%, of total compensation…" In our opinion, this is an extreme reaction to the heavy use of stock options in executive compensation during the market run-up and its aftermath. In some companies, cash compensation at the CEO level makes*

up 20% or less of total compensation, with options valued at their Black-Scholes values at grant.

Certainly, equity incentives have been overdone. But to use competitive surveys, which overstate the value of options, to set "competitive levels of overall compensation for executives," and then convert a major portion of those equity values to cash compensation (in the form of higher salaries and bonuses) is unnecessary and would be a serious mistake. The right answer, in our opinion, is for cash compensation to be competitive with market ***cash*** *compensation, and for equity grant values to come down to more reasonable and sustainable levels.*

4.02. Bar Against Retention Payments.

The Company's by-laws should prohibit the use of "retention" payments at any time following completion of the existing bankruptcy retention program other than in situations such as acquisitions, dispositions, facility closing or other events where the board determines that a limited retention program has a specific objective warranting its use.

FWC Comment: *The Breeden Report recommends* ***against*** *the use of large cash "retention" payments not tied to performance and otherwise without ostensible purpose. We concur. To the list of valid purposes, however, we would add retention of key top management replacements for management succession purposes, like has been done at GE, and for those with critical skills.*

The Breeden Report is not against vesting requirements for stock options, restricted stock and other long-term incentive grants. Here, however, the purpose is not retention per se, but the encouragement of a long-term performance perspective.

An important aspect of vesting requirements not yet addressed by governance advocates and compensation professionals is prevention of their use to discourage the taking of principled views contrary to top management and quitting (or being fired) for matters of conscience. In such events, the terminated employee should receive at least a pro rata award based on time worked. The same should apply to directors' compensation.

4.03. Severance Programs.

The Company's Articles of Incorporation should limit the maximum severance that can be paid to any employee absent a shareholder vote. Initially this limit should be $10 million in the case of the CEO, and $5 million for any other employee. If the board terminates an employee for poor performance, the maximum severance allowable should be not more than 50% of the amounts for termination for any other reason. These amounts should be adjusted every five years, but only upon prior approval by shareholders.

FWC Comment: *We concur with the Breeden report's acceptance of reasonable severance protection as a "normal and quite necessary part of any company's compensation program," with its ideal purpose being "a bridge of income to cover an employee until he or she can find another job." The report also acknowledges the importance of severance protection in recruiting executives from outside the company.*

The Breeden Report, however, objects to four aspects of severance agreements, one of which was relatively unique to WorldCom and three which are quite common.

***First**, severance packages with extremely large payment obligations should be avoided. We concur. In Mr. Ebbers' case, Mr. Breeden calculates his severance at 250 times his salary.*

***Second**, the Breeden Report objects to "evergreen" contracts which automatically renew and extend each year. We **favor** evergreen contracts so long as the Compensation Committee has the right to give notice not to renew, or to amend the agreement unilaterally, so long as advance notice is given and such non-renewal or amendment is not deemed to be a termination of employment triggering severance. Also, no contract should renew beyond the executive's normal retirement date except with the Committee's express consent (retirement is not a valid reason for severance). The alternative to evergreen contacts is fixed-term contracts which would need to be renegotiated periodically, e.g., every three years.*

***Third**, the Breeden Report objects to severance calculated as a multiple of then-current salary or salary and bonus. The report calls these "autopilot" agreements and objects to the characteristic that, an increase in salary means an increase in severance. But this is a logical characteristic of evergreen contracts which otherwise would become outdated unless adjusted periodically to continue to serve their purpose. This would open the contract to renegotiation, something an "evergreen" provision avoids.*

It is quite common for many benefits to be tied to salary level, and to automatically increase when salaries increase. This is not a corporate governance abuse. The important thing is for Compensation Committees to be made aware of the total cost to the company of potential severance payments when the agreements are first adopted and periodically thereafter.

***Fourth**, the Breeden Report objects to executives receiving the same severance if terminated for poor performance as otherwise. We acknowledge the public has trouble accepting severance for CEOs and other senior executives who fail. But what is the alternative? Performance judgments can be subjective, and disagreements about performance in severance likely would lead to legal disputes. The better solution would be for there to be "no fault" terminations (except, of course, "for cause"), with severance being limited to continued salary and benefits. Inclusion of target bonus in severance for terminations caused by poor performance is a perversion of the pay-for-performance concept.*

4.04. Shareholder Approval of Mega Awards.

The Articles of Incorporation should establish an overall limit on compensation in any single year for any individual without a vote of shareholders. As an initial level the board should fix an amount of not more than $15 million, though the board should be free to establish a lower limit. The Articles should also provide a mechanism for adjusting this limit every five years with a shareholder vote.

FWC Comment: *Abuses and lax governance at old WorldCom do not justify this type of rule at other companies. Like the $1 million salary cap under IRC §162(m) or the 2.99 times severance cap under IRC §280G, the limit could soon become the norm.*

4.05. Limitation of Stock Options.

The Articles of Incorporation should prohibit the granting of stock options for a minimum of five years following emergence from bankruptcy, and thereafter until such time as the shareholders affirmatively vote in advance to restore their use. Equity incentives during this period should be limited to restricted stock, with the Compensation Committee determining both the amount of individual awards and appropriate performance conditions for grants or vesting. Restricted stock awarded after the date of emergence from bankruptcy should not have a vesting period shorter than four years.

FWC Comment: *Mr. Breeden has an obvious bias against stock options, and believes that massive grants to the CEO and CFO "… created strong incentives to hype the stock, or to release misleading or outright false information." Whether true or not, it is no reason to ban reasonable grants of a perfectly valid equity incentive device to executives and other employees.*

The Breeden Report favors restricted stock over stock options, and makes an interesting point we had not heard before in favor of performance-based restricted stock: "Since both restricted stock and cash compensation are both expensed, and since executives can buy stock on the open market (and can be required to do so), there is not a strong reason for granting restricted stock rather than simply paying cash ***unless*** *there are performance hurdles to vesting."*[*] *(emphasis added)*

Stock options provide upside leverage which an equivalent value of restricted stock cannot. We believe they have a role in a post-expensing environment, accompanied by restricted stock grants with long vesting requirements and/or performance hurdles for vesting.

[*] Page 85, footnote 75

4.06. Long Term Equity Retention.

The by-laws should require retention of not less than 75% of the net after tax value of all equity awards to employees until a date at least six months following the termination of their employment, other than in hardship situations approved by the board. The board should also set mandatory levels of stock ownership for different levels of management to be reached over a gradual period of time and thereafter to be maintained.

FWC Comment: *We believe that the basic purpose of equity incentives for management is to enable executives to build ownership positions in their company's stock through their performance. Equity incentives without an ownership intent enable executives to "cash out" early, and align executives' interests with those of short-term traders or speculators. The same equity incentives with an ownership intent or requirement, however, align executives' interests with long-term investors. Unfortunately, since most executives are advised by their financial advisors to diversify their company stock position, it is necessary for companies to have ownership guidelines or rules for their senior executives. However, these should be* ***guidelines****, not mandated requirements. There should be no requirement for executives to purchase shares on the open market with their own funds.*

We generally favor the Breeden Report's recommendation on equity retention, but believe it is unnecessarily onerous to require ***both*** *a minimum ownership guideline (e.g., 200-300% of salary)* ***and*** *a career retention ratio (e.g., hold at least 75% of net after tax value of earned equity incentives until at least six months following termination of employment).*

We favor both types of ownership requirements and believe they can work together. But if the stock retention ratio is to apply for the executive's full career, then there is no need, in our view, for ownership guidelines as a multiple of salary. If, however, the company adopts the ownership multiple concept, then there is a need for the retention ratio on top of the multiples to prevent executives from "flipping" new stock once the ownership multiple has been reached. However, in this case the retention-ratio requirement need only apply for six months to a year after the stock has been earned since its purpose is to prevent the potential for abuse of insider information.

If companies want their executives to own stock, then they should design plans that facilitate ownership, e.g., reload options and voluntary deferrals of cash into stock.

We strongly support the Breeden Report's recommendation that career ownership requirements should extend ***at least*** *six months, and preferably a year, following termination of employment. This removes an incentive for executives in companies with a failed business model from quitting in advance of bad news to protect their equity position.*

4.07. Retention of Compensation Consultants.

Where used, compensation consultants should be independent and should be retained directly by the Compensation Committee when studying pay levels for management. Percentile benchmarking should not ever be practiced except to provide broad market reference points, and any such consultants should have a mandate to identify for the Committee's reference the lowest reasonable level for proposed awards.

FWC Comment: *We concur that compensation consultants should be hired by the Committee when they are being asked to advise or assist the Committee in setting executive pay levels. However, if their role is to provide management with competitive survey data, they need not be hired directly by the Committee.*

We also concur that the consulting firm retained to assist the Committee needs to be independent of management. "Independence" needs to be considered in two dimensions. ***First****, if the same firm providing executive compensation consulting services to the Committee also provides* ***non-executive compensation consulting services*** *to the Company, e.g., benefits, actuarial, insurance brokerage, HR outsourcing, its independence can be questioned. At minimum, these services need to be identified and quantified to the Committee, and be made subject to its approval in the same fashion that Audit Committees approve the providing of non-audit-related services by the company's auditors.*

Second*, if the same firm providing executive compensation consulting services to the Committee also provides* ***executive compensation consulting services*** *to management, then a real conflict exists because it is likely the same individuals are providing both services. One person cannot simultaneously serve two masters, which may have conflicting interests, on the same subject. Some committees may choose to prohibit this joint service and build a wall between the committee's consultant and management. This may be right for some companies but likely wasteful, inefficient and unnecessary, for most. There are many advantages when the consultant can work with management on compensation matters which will come before the Committee for decision so long as the consultants work and recommendations are not under management's control. The important principle to stress is that the consultant working with management on matters coming before the Committee is* ***always acting on behalf of the Committee.***

Finally, we concur that use of surveys to set pay levels, particularly if the target is unjustifiably set at the 75th percentile, leads to a "… consultant-driven spiral in compensation that does not serve shareholder interests." We favor using a range of competitive practice to establish boundaries for reasonableness of pay actions, and we concur with the recommendation that, for example, if 75th percentile data is provided, the 25th percentile also should be included.

4.08. Mandatory Expensing of Options.

The Articles of Incorporation should provide that all stock options, if granted, and all other forms of equity-based compensation, shall be expensed on the Company's profit and loss statement unless expressly prohibited by GAAP.

FWC Comment: *So long as FASB offers a choice on option expensing, and both choices are permissible under GAAP, option expensing is* ***not*** *a matter of governance. Expanded disclosure provides all investors with the same information whether or not options are explicitly expensed.*

4.09. Evergreen Contracts Prohibited.

The Company's by-laws should not permit it to enter into "evergreen" employment contracts or any employment agreement with a total duration of more than three years.

FWC Comment: *Our views on "evergreen" contracts are discussed under recommendation* ***4.03*** *(Severance Payments), particularly points two and three. So long as the Committee has the right to give notice not to renew the contract, or to amend the contract unilaterally, shareholder interests are served and the need for fixed-term renegotiations is avoided.*

However, it is important for Committees to be aware of these renewal dates and periodically review the contract terms and affirmatively decide to let the contract continue unchanged, or to initiate changes.

THE COMPENSATION COMMITTEE

7.01. Committee Membership.

The Articles of Incorporation or by-laws should require a Compensation Committee of not less than three independent members, each of whom should have experience with compensation and human resources issues.

FWC Comment: *We concur, except that it need not be part of the company's Articles of Incorporation or by-laws.*[**]

7.02. Meeting Requirements.

The by-laws should set specific minimum requirements for the number of meetings and level of activity of the Compensation Committee as recommended above as an initial set of requirements. All compensation consultants advising on management compensation should be retained by the Compensation Committee directly.

[**] What should be included in the Articles of Incorporation or By-laws is a legal matter. We believe it should suffice if these Committee recommendations be in the Committee's charter

FWC Comment: *This is really two separate recommendations. On the first, the report text supporting the recommendation advises that the Committee meet at least four times a year, and that members attend refresher courses annually. A requirement that companies provide or sponsor training for directors is likely to be part of the NYSE's rules. Training in executive compensation issues is a good idea for Compensation Committee Chairs and new members because of the complexity of the subject and potential for mistakes and abuse if the committee is less sophisticated than an aggressive management. But, a recommendation for annual refresher courses seems excessive.*

We fully support the second recommendation, and note that the text supporting the recommendation states that "…any such consultants should be free to work with management as well as with Compensation Committee members." We support this also, with the caveat that a consultant cannot serve two masters. Any work done with management should be done with the foreknowledge and consent of the Committee chair. And the consultant must keep in mind that, if the work is to be presented ultimately to the Committee, the consultant's responsibility is always to the Committee, not management.

Also, these recommendations need not be part of the company's by-laws.

7.03. Leadership Rotation.

The by-laws should provide that the chairman of the Compensation Committee should have a term limit of three years as chairman, though such individual may remain as a member of the Compensation Committee beyond such time.

FWC Comment: *We favor Committee Chair rotation periodically, but five years or longer is preferable to three, particularly if the Chair is experienced and resolute. And, in our experience, it is better for the Chair to be a member of the Committee before becoming Chair rather than after.*

7.04. Compensation Committee Fees.

Members of the Compensation Committee should receive a retainer to be established by the board, but which should not be less than $35,000 for members of the Committee, and not less than $50,000 for the chairman of the Committee.

FWC Comment: *We see increased pay for committee chairpersons and members, particularly for the Audit and Compensation Committees, but not in these amounts. This recommendation may be right for WorldCom, but not for others. We agree a good Compensation Committee Chair does considerable work outside Committee meetings, and deserves a robust retainer. However, to pay a robust retainer to Committee members would seem neither necessary nor appropriate.*

7.05. Review of Related Party Transactions.

The charter of the Compensation Committee should require it to meet with the Director of Human Resources and the General Counsel at least semi-annually to review policies against any form of related party transactions, and to review other human resources and compensation complaints, disputes or issues.

FWC Comment: *This may be right for WorldCom but overkill for others. We do favor, however, the head of human resources and/or executive compensation having a direct relationship with the Compensation Committee Chair. And the head of HR or the General Counsel should have an affirmative responsibility to notify the Committee or its Chair of violations of (1) SEC insider trading rules (or the Company's rules if tougher), (2) prohibitions against third-party transactions, or (3) violations of the Company's Code of Business Conduct and Ethics.*

7.06. Annual Review of Director of Human Resources.

The Director of Human Resources' performance should be formally reviewed by the Compensation Committee not less than once a year. The Director of Human Resources should provide a confidential questionnaire to the Compensation Committee annually regarding all major compensation issues and awards.

FWC Comment: *This may be reasonable in certain situations, but we question with whom the performance review should be discussed – presumably the CEO and the head of HR individually. There is no supporting text in the Breeden Report for the second recommendation, and we do not know what it means.*

7.07. Required Resources for Compensation Committee.

The Compensation Committee should identify and retain professional advisors to provide analytic support to the Committee. Compensation consultants should always be asked to identify the full range of reasonable levels of compensation for senior executive positions as an analytic baseline.

FWC Comment: *Concur; also see our comments related to recommendation **4.07**.*

7.08. Training for Compensation Committee Members.

The board should establish and disclose annual training requirements for members of the Compensation Committee as a qualification for continued Committee membership.

FWC Comment: *Annual training is unnecessary and expensive; see other reservations discussed under recommendation **7.02** comments.*

7.09. External Compensation Oversight.

The Compensation Committee should actively review the performance and independence of the Company's compensation advisors.

FWC Comment: *We strongly support this recommendation. It should be included in the Committee's annual self-evaluation process, with results reported to the Board as well as to the compensation advisors.*

BOARD COMPENSATION

3.01. Board Retainer.

The level of annual board retainer should be substantial, with a recommended level of not less than $150,000 per year. Additional fees such as meeting fees should not be paid.

FWC Comment: *The Breeden Report recommends a robust retainer for Board service, which we strongly support, in recognition of the increased time demands, responsibilities and accountabilities imposed on outside directors. The specific amount of $150,000 a year may be right for WorldCom but not for many smaller companies which cannot afford this level of remuneration.*

Whether or not board meeting fees should be paid on top of the retainer is a matter of board choice, and is not a governance issue.

We support the recommendation to drop Board meeting fees for regular board service as a nascent trend.

3.02. Mandatory Stock Investment.

The Company's by-laws and qualification standards for directors should require each director to make purchases of common stock in each year equal to at least 25% of cash compensation received. Such purchases should be either open market purchases (subject to all window requirements) or fixed periodic purchases from the Company at full market prices at the applicable time.

FWC Comment: *The Breeden Report is against the granting of stock options for outside directors. The report goes further, however, and advises against use of* ***any equity*** *for directors. Instead, it recommends all cash payments, with the director* ***required*** *to buy stock on the open market (or from the company at full market prices) equal to 25% of the retainer.*

We would advise strongly against this recommendation, and instead suggest that 50% of the total retainer be automatically converted to deferred stock each year and then held until six or 12 months following termination of board service.

The difference in share ownership between these two approaches is substantial. At a $150,000 annual retainer and a $60 stock price, the 25% market purchase results in 625 real shares a year, whereas our proposal results in 1,250 deferred shares a year.

3.03. Long Term Stock Retention.

All stock acquired in satisfaction of the mandatory investment program should be held until a date which shall be not less than six months following the termination of a directorship other than in the event of death or disability, in which case resale restrictions should lapse immediately.

FWC Comment: *We concur with respect to fees paid in deferred company shares.*

3.04. Equity Grants.

The Company's Articles of Incorporation should restrict directors from participating in any equity-based compensation program of the Company. Director compensation should be exclusively paid in cash, with a requirement to purchase equity in the open market or through the Company and to hold such shares throughout their tenure.

FWC Comment: *Do not concur; see our response to recommendation* ***3.02*** *above.*

3.05. Advance Disclosure of Stock Transactions.

All stock sales or other equity transactions by directors or senior officers should be disclosed to the market in advance through a press release by the Company not less than two days before any such transaction. Derivative transactions should be prohibited for directors or employees. The Company should establish window policies for all purchases and sales by directors or any employee.

FWC Comment: *Fully support.*

* * * * *

Whether the Breeden Report will "have legs" remains to be seen. Certainly, many of its recommendations are extreme, and will not be voluntarily adopted by other companies. All the recommendations were essentially imposed on MCI by the court. Several of the recommendations, however, are of interest for possible adoption by companies interested in advancing "best practices" in compensation committee governance of executive compensation.

This summary of recommendations and views was prepared by Fred Cook who is available at (212) 986-6330 for general questions. This piece, and other writings, is available on our website at www.fwcook.com