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New York • Chicago • Los Angeles

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Year in Review (2002)—Navigating the Complexities of Executive Compensation Reforms

Many have characterized 2002 as the year that experienced the most dramatic and sweeping regulatory changes in Corporate America since the 1930s. In response to sharp market declines, accounting scandals and corporate malfeasance, we observed almost every conceivable agency, regulatory body, and business organization throw its respective hat into the ring in support of changes to current corporate practices, including corporate governance, auditing, and executive compensation. We witnessed the accounting community, Congress, stock exchanges, as well as corporate governance experts and watchdogs promulgate new standards, requirements and reforms for corporate actions, each ostensibly with one goal in mind: to eradicate the abuses and indignities that have become so prevalent in recent years.

With the myriad reforms proposed or implemented in 2002, this memorandum attempts to reconcile in one repository the key accounting, legislative and regulatory developments that impacted the executive compensation field. Its purpose is not to provide a comprehensive analysis of each of the reforms, but rather to highlight 2002's developments and their concomitant implications for executive reward programs. Additional details for each development may be found in the referenced "alert" letters on our website at www.fwcook.com.

This memorandum is divided into four distinct categories, as follows:

1. **Accounting Developments;**
2. **Corporate Governance Reforms;**
3. **Securities and Exchange Commission Requirements; and**
4. **Tax Developments**

1. ACCOUNTING DEVELOPMENTS

➢ *Accounting for Stock Options—The Debate Continues*

The continuing and increasing debate over how to account for stock options had strong proponents on both sides in 2002, from Alan Greenspan to George W. Bush, from Senators on one side of the aisle to those on the other, from institutional investors to publicly traded companies.[1] There seemed to be as many

[1] See our July 30, 2002 Alert Letter.

arguing to account for stock options as an expense as there were arguing against it, although the pendulum appears to be shifting towards those arguing for expensing options, as outlined below:

— On February 13, 2002, Senator Carl M. Levin (D-Mich.) introduced a bill to deny a corporate tax deduction for option gains in the year of exercise unless the same amount was charged against earnings.[2] Ostensibly a tax bill, the Senator's purpose for introducing the bill was to "address a costly and dangerous double standard that allows a company to take a tax deduction for stock option compensation as a business expense while not showing it as a business expense on its financial statement."[3] The bill has since been read twice and referred to the Committee on Finance.[4]

— On May 14, 2002, Standard & Poor's (S&P) announced that as part of its initiative to improve the consistency of reported financial results across companies, it had adopted a new definition of operating earnings referred to as "Core Earnings." This new measure begins with a company's after-tax earnings generated from its principal business and then makes a series of adjustments for, among other things, employee stock option expenses.[5] Thus, company Core Earnings that reflect the "cost" of stock options will be included in the S&P's financial reports and databases, which are widely used by investors and analysts.

— On July 24, 2002, TIAA-CREF announced a widespread initiative in which it would actively lobby the chairmen of over 1,750 major public companies in which it holds a major investment position to begin expensing options.[6] The Council of Institutional Investors, which represents over 130 pension funds, also indicated a desire to initiate a similar campaign.[7]

— The European Union is requiring that all companies listed on European stock exchanges switch to The International Accounting Standards Board (IASB) standards no later than 2005 (2007 for companies also listed in the U.S).[8]

— On November 7, 2002, IASB issued its Exposure Draft on Accounting for Share Based Payment, calling for the expensing of stock-based compensation.[9]

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2 "Ending the Double Standard for Stock Options Act" (S. 1940); also see our Alert Letters of March 4 and February 28, 2002.

3 *Ibid.*

4 See "Bill Summary and Status for the 107th Congress," http://thomas.loc.gov/cgi-bin/ bdquery /z?d107:S01940.

5 See "Standard and Poor's to Change System for Evaluating Corporate Earnings," Standard and Poor's Press Release, May 14, 2002 and our Alert Letter, June 3, 2002.

6 http://money.cnn.com/2002/07/24/news/tiaacref_options.

7 *Ibid.*

8 See "Accounting's White Knight," *Fortune*, September 20, 2002.

9 http://www.iasb.org.uk/cmt/0001.asp

— Finally, the Financial Accounting Standards Board (FASB), on November 18, 2002, released an "Invitation to Comment" in response to the IASB's Exposure Draft on "Accounting for Share Based Payment," which is intended to educate FASB's constituents about, and solicit feedback on, the similarities and differences between the IASB proposal and the provisions of FASB Statement No. 123 (FAS 123). FASB intends to use this feedback when it considers whether changes should be made to FAS 123, including the ability to account for employee stock compensation under APB Opinion No. 25 (Opinion 25).[10]

In addition to the above actions and assertions, the announcement by Coca-Cola that it would begin expensing the cost of stock options[11] has influenced over 200 companies, at our informal last count, to indicate that they would also voluntarily account for stock option grant costs using FAS 123. Prior to Coca-Cola's announcement in 2002, only two companies, Boeing and Winn Dixie Stores, had previously adopted FAS 123 for expense recognition purposes. In response to the sudden adoption of FAS 123 by many companies, the FASB on October 4, 2002, issued an Exposure Draft to facilitate the transparency of footnote disclosure between FAS 123 adopters and those taking a "wait and see" approach, while remaining under Opinion 25.[12] The Exposure Draft also provides transitional provisions for those companies that adopt FAS 123.[13]

Despite some negative media attention regarding stock options and the role they may have played in various corporate scandals, stock options will continue to be a powerful tool in aligning the interests of management with those of shareholders. With persistent investor scrutiny and the possibility of a change in accounting treatment, the relative and absolute "cost" of a company's stock option program and the related plan design are issues that warrant continued and careful attention. For more information on the stock option debate, see our July 30, 2002 Alert Letter.

➢ ***EITF Issue No. 00-23—Continuing Deliberations***

In our summary letter last year, we highlighted the fact that the Emerging Issues Task Force (EITF) was continuing its deliberations from 2000 on its long running stock compensation project referred to as Issue 00-23.[14] At that time, we indicated that the approximately 30 issues relating to accounting for stock compensation under Opinion 25 and Interpretation 44 the EITF initially began addressing in

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10 A copy of the FASB's Invitation to Comment, "Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, Accounting for Stock-Based Compensation, and its Related Interpretations, and IASB Proposed IFRS, Share-based payment," is currently available under nine separate files on FASB's website at http://www.fasb.org; see also our December 23, 2002 Alert Letter for a summary comparison of Statement 123 and the IASB proposal.

11 See "The Coca-Cola Company will Expense All Stock Options," Coca-Cola Company Press Release, July 12, 2002.

12 A copy of the Exposure Draft, "Accounting for Stock-Based Compensation – Transition and Disclosure," is available on the FASB's website at http://www.fasb.org; see also our October 11, 2002 Alert Letter.

13 *Ibid.*

14 See our April 1, 2002 Alert Letter.

2000 had subsequently escalated to over 60 issues in 2001. In 2002, this number grew to roughly 71 issues and sub-issues. After meeting nine times over the course of approximately two years, the EITF in 2002 quietly concluded its deliberations on Issue 00-23.

The EITF tackled issues including, among other things, tax reloads, stock option loan forgiveness, repricings, conversions, transferability restrictions and cashless exercises. As a result, it is now more challenging than ever to conclude with certainty the accounting consequence of various actions. While an overview of each of the various actions and issues is beyond the scope of this summary, see our August 2, 2002 Alert Letter for our interpretation of permissible designs and actions that comport with Issue 00-23.

2. CORPORATE GOVERANCE REFORMS

In our introduction to this memorandum we mentioned that a number of noteworthy and prominent organizations, agencies, stock exchanges and associations responded expeditiously to the accounting and corporate scandals of 2002. This section highlights those organizations and identifies their respective governance reform proposals:

- ***The Conference Board***

  On September 17, 2002, the Conference Board, arguably the world's leading business network, joined other regulatory and business organizations in proposing a wide-ranging series of reforms intended to strengthen corporate compensation practices and restore trust in America's corporations and financial markets. Through its Commission on Public Trust and Private Enterprise, the Conference Board issued the first in a series of reports to help shepherd in best practice governance reforms. Part 1, summarized below, focuses on seven basic executive compensation principles, including suggested best practices for implementation:[15]

  — ***Compensation Committee's Responsibilities:*** The Commission stressed that committees need to be strong and independent, cognizant of the inherent conflict of interest in management's views on its own compensation, and be held accountable in their decision-making. Additionally, the Commission recommended that the committee be comprised of only truly independent members, who have the authority to hire and fire any outside advisors and consultants who advise it.

  — ***Performance-Based Compensation:*** The Commission believes that properly structured performance-based compensation can be a powerful and effective tool in advancing a corporation's interests. "Properly structured" means policies that are appropriately tailored to each corporation's unique needs, goals that are designed to support and

[15] See "Findings and Recommendations, Part 1: Executive Compensation," The Conference Board – Commission on Public Trust and Private Enterprise, September 17, 2002 and our October 9, 2002 Alert Letter.

reinforce long-term strategic imperatives, and "claw back" provisions to ensure participants do not benefit from their own wrongdoing.

— ***The Role of Equity-Based Incentives:*** The Commission stressed that equity vehicles, although an effective incentive if designed properly, should be used in a reasonable and cost-effective manner. These plans, the Commission believes, should be designed to support the company's performance goals and balance their costs with their perceived value. Additionally, the Commission endorsed broad-based arrangements suggesting that they may serve a desirable purpose. Finally, the Commission believes that companies should clearly disclose the associated dilution and cost impact of its equity programs.

— ***Creating a Long-Term Focus:*** In this principle, the Commission expressed its desire for key executives and directors to acquire and hold a meaningful equity position in the company on a long-term basis. The Commission recommended utilizing ownership guidelines and "retention ratios" (where some percentage of shares acquired through equity awards cannot be sold) to achieve optimal ownership levels over time.

— ***Accounting Neutrality:*** Although not a unanimous principle (Intel's Andy Grove disagreed with the Commission on this principle), the Commission called for the expensing of stock options. Consequently, the Commission believes that compensation decisions should be based on the appropriateness and effectiveness of the compensation structure and programs, rather than simply on the accounting implications.

— ***Shareholder Rights:*** Continuing its focus on controlling, or at least limiting, dilution, the Commission recommends that shareholders should approve all stock plans and material modifications of existing arrangements, including repricings.

— ***Transparency and Disclosure:*** As the restoration of trust was one of the key tenets behind its creation, the Commission recommends full and understandable disclosure of executive compensation. Best practice recommendations would include disclosing the effects of equity-based compensation on EPS and dilution levels, requiring executives to provide public advance notice of their intention to sell company stock, and promptly disclosing any new executive employment agreements.

Had these principles been announced a few years ago, some might have characterized them as patently obvious. After the events that have transpired over the last year or so, however, such a statement of obviousness loses its force. Although the action steps into which these principles translate are really quite simple in concept, we believe that strength and conviction will be needed to carry them out.

- ***Institutional Shareholder Services***

Institutional Shareholder Services (ISS), a provider of proxy voting and corporate governance services and a leading advocate for corporate reform, developed a new way to rate companies' corporate governance structures and issued new proxy voting guidelines in 2002.[16] Each is described below:

1) ***Corporate Governance Quotient***

In the summer of 2002, ISS launched its Corporate Governance Quotient (CGQ), which is "a new measure to rate companies on their corporate governance structures relative to their peers and an overall market index."[17] Initially, the CGQ was a rating based on 51 factors within seven "core topics," including board structure and composition, executive and director compensation, and director education.[18] ISS recently announced that the number of factors it will assess under the CGQ has grown to 61 within eight "core topics."[19] ISS will calculate two CGQ scores for each company in the Russell 3000 Index, i.e., (1) a CGQ relative to its Standard & Poor's Industry and (2) a CGQ relative to its market index. These scores will then appear on the front page of each ISS proxy analysis. Although the methodology for calculating a CGQ is proprietary, examples of factors that will presumably better a company's score include:

-- Low "cost" of option plans;
-- Conformity with ISS' option repricing guidelines;
-- No non-shareholder approved option plans;
-- No compensation committee interlocks;
-- No pension plans for nonemployee directors;
-- High levels of officer and director ownership levels; and
-- Stock ownership guidelines for executives and directors.

2) ***2002 Policy Changes***

In addition to adopting the CGQ, ISS modified its prior policy guidelines for 2002 proxy voting recommendations. The most significant changes in the compensation area concern option repricings and performance-based stock options.[20]

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16 See our June 13, 2002 and January 8, 2002 Alert Letters, respectively.
17 According to ISS literature, CGQ's are being calculated initially for companies comprising the Russell 3000 Index, with plans to expand the universe of coverage in the near future.
18 See http://www.isscgq for more information, including a list of the factors.
19 See "Institutional Investors Apply Corporate Governance Data to Investment Decisions—Expanded scoring universe, 61 variables and real-time updates," http://www.issproxy.com/pdf/CGQ_expanded_scoring_01.29.03.pdf.
20 See our January 8, 2002 Alert Letter.

-- ***Repricings:*** ISS announced that in connection with requests for evaluating shareholder approval for stock option repricings, it will evaluate repricings using three “brightline tests,” a violation of any of the three carrying a high risk of a recommendation to vote against the proposal. First, ISS will now run the repricing provisions through its binomial models to ensure the exchange is value-for-value (rather than share-for-share), where the “value” of the new awards should be equal to or less than the “value” of the old awards tendered. Second, directors and top five named executive officers should be excluded from any repricing opportunity. Finally, management’s rationale for the repricing will be factored into the evaluation. In addition to these “bright-line” tests, ISS will recommend voting against any requests for new share authorizations if (1) a stock plan expressly permits option repricing without shareholder approval, or (2) a company has a history of repricing without shareholder approval and its stock plan does not expressly prohibit future repricing without shareholder approval. For 2002, ISS clarified that the following all constitute repricings under its guidelines: (1) a reduction in exercise price of outstanding options, (2) cancellation and re-grant of options at lower exercise prices (including six-month and one-day cancellations and “bullet” options [options with long-vesting schedules and accelerated vesting if the participant agrees to cancel an underwater option six months and one-day after receiving the new option]), (3) substitution of restricted stock for underwater options, and (4) underwater option buybacks.

-- ***Performance-Based Stock Options:*** Although ISS is supportive of performance-based stock options, it announced that it does not favor shareholder proposals that are rigid in requiring that *all* option awards must be performance-based or that *all* option participants should receive only performance-based stock options. ISS believes that companies need flexibility to grant conventional options so as not to be at a competitive disadvantage.

➢ ***Sarbanes-Oxley Act of 2002***

On July, 30 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the “Act”).[21] This Act endeavors to protect investors by enhancing corporate responsibility, overhauling corporate governance and financial obligations, and strengthening reprisals for crimes in connection with corporate fraud. Although the Act’s provisions have far reaching implications for a variety of fields and topics, the following outlines those aspects of the Act specifically related to executive compensation:[22]

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21 The Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 2002 HR 3763 (July 30, 2002), 15 U.S.C.A. § 7201, et. al.

22 See our August 9, 2002 Alert Letter.

1) ***CEO/CFO Certification of Financial Statements:*** The Act requires CEOs and CFOs to certify the accuracy of their company's financial statements. The Act also requires CEOs and CFOs to reimburse the company for any compensation received or any profits realized from the sale of securities for the 12-month period following initial release of financial statements that have to be restated due to material noncompliance, as a result of misconduct, with any financial reporting requirement under the securities laws.

2) ***Executive and Director Loans:*** The Act prohibits companies from extending or maintaining credit or arranging for the extension of credit, in the form of a *personal loan* to or for any director or executive officer of the company.

-- ***Existing Loans:*** Existing loans or extensions of credit *currently outstanding* will not be subject to the provisions of the Act, provided that there are no *material modifications* to such loans or extensions of credit.

-- ***Companies in the Lending or Credit Business:*** This provision does not prohibit home improvement and manufactured home loans or any extension of credit under an open end credit plan or charge card, provided that such extensions of credit are made in the ordinary course of the company's consumer credit business, are of a type generally made available by the company to the public, and are made by such company on market terms.

-- ***Interpretation of "Personal Loan":*** As of the drafting of this memorandum, no official guidance has been issued with respect to what is and is not exactly covered under the term "personal loan." Although many legal experts have opined on their interpretations of the Act's meaning of "personal loan,"[23] as currently written and without official guidance, it is possible that the Act may indeed cover cash advances (even for business purposes), participant loans from 401(k) plans, and cashless exercises of stock options.

3) ***Accelerated Stock Transaction Reporting:*** The Act requires executives and directors to report on Form 4 any transaction involving their equity holdings within two business days of the transaction, which significantly reduces the previous time period of ten days following the end of the month in which the transaction occurred.

4) ***Prohibition of Insider Trading During Pension Fund Black-Outs***: Officers and directors are prohibited under the Act from equity transactions during "black-out" periods when employees of the company

[23] See "Sarbanes-Oxley Act, Interpretive Issues Under S. 402 – Prohibition of Certain Insider Loans," http://www.realcorporatelawyer.com/loan25firms.pdf.

are precluded from selling stock in a 401(k) or other defined contribution plan.

- ***NYSE and Nasdaq Proposals***

During 2002, both the New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq) presented to the SEC separate rule proposals covering shareholder approval of equity-based plans and corporate governance. This was not the first year that either exchange has submitted proposals or updated its respective listing requirements relating to these subjects.[24] The filings and their subsequent revisions and clarifications, however, indicate that both markets continue to respond aggressively to investor concerns regarding shareholder dilution and related corporate governance issues. At the time of the drafting of this memorandum, the SEC has not yet issued its final ruling on the proposed rule changes for either exchange. The following highlights the key concepts of both market proposals:

1) ***NYSE Proposals***

The NYSE proposal, which was prepared by the recently formed Corporate Accountability and Listing Standards Committee, [25] was announced on June 6, 2002. Following its release, the NYSE solicited public comments and released the details of its final proposal for SEC approval on August 16, 2002. A summary of the compensation-related areas within the NYSE proposal is provided below[26]:

-- ***Shareholder approval of equity compensation plans:*** Shareholder approval will be required for *all* equity compensation plans, with limited exceptions, and any *material revisions* (i.e., repricings) to such plans. The consequences of this proposal will eliminate the historical exemptions from shareholder approval applicable to grants funded with treasury shares and "broad based" plans.

-- ***Broker votes on equity compensation proposals presented by management:*** The proposed rule would prohibit brokers from voting on equity compensation plan proposals (usually proposals to increase share authorization for equity compensation plans) unless specific instructions are provided by the shareholder. Historically, brokers have been permitted to vote shares held in "street name" on routine proposals without prior shareholder instructions to the extent the increase did not result in a new equity compensation authorization in excess of five percent of the outstanding common shares or extend the term of the plan.

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24 See our June 12, 2002 for a historical overview of proposals relating to shareholder approval of equity based compensation.

25 The Corporate Accountability and Listing Standards Committee, composed of 13 members plus the Chairman of the NYSE, was formed following a request from the SEC to review the NYSE's corporate governance listing standards.

26 See our October 15, September 10, and July 24, 2002 Alert Letters.

-- ***Structure of Compensation Committee:*** Listed companies will be required to maintain a compensation committee comprised solely of independent directors, where independence is defined as no "material relationship" with the company directly as a partner, shareholder or officer of an organization that has a relationship with the company. The proposal leaves the determination of independence with the board, and requires that the basis for that determination be disclosed in the annual proxy statement.

-- ***Compensation Committee Charter:*** The compensation committee will be required to have a formal written charter that addresses its purpose (e.g., discharging the board's responsibilities related to compensation of executive officers and preparing the annual committee report for the proxy statement), its duties and responsibilities (e.g., reviewing and approving corporate goals and objectives applicable to CEO compensation, evaluating CEO performance, and determining CEO payouts), and a process for evaluating the performance of the committee itself. The charter would also be expected to address committee member qualifications, the process for appointing and removing committee members, and the structure and operating procedures of the committee. Additionally, the charter should provide the committee with authority to hire, terminate and determine the scope of its relationship with its own consultant to assist with compensation issues.

-- ***Audit Committee Member Compensation:*** Members of the audit committee would be prohibited from receiving any compensation other than director's fees from the company.

-- ***Disclosure of Corporate Governance Guidelines:*** Listed companies would be required to disclose on the company's website and in the annual report certain corporate guidelines, which include the committee charters, policies regarding board access to independent advisors, and the director compensation program.

2) ***Nasdaq Proposals***

The Nasdaq announced its own corporate governance proposal on May 24, 2002, with clarifications submitted on August 21, 2002, following the release of the NYSE proposal. While not identical, the compensation-related aspects are relatively similar to those of the NYSE, as summarized below:[27]

-- ***Shareholder approval of equity compensation plans:*** Like the NYSE proposal, shareholder approval will be required for all

[27] See our September 10, 2002 Alert Letter.

equity compensation plans,[28] with limited exceptions, and any material amendments to such plans. Unlike the NYSE, however, the Nasdaq does not define what constitutes a material amendment to the plan. Instead, the Nasdaq states that it will continue to provide guidance on such issues. As a result, a specific shareholder approval requirement on repricing is not included.

-- ***Independent Director Approval of Executive Officer Compensation:*** Compensation provided to the CEO and other executive officers will require approval by either an independent compensation committee or a majority of independent directors. Where the NYSE proposal leaves the determination of independence to the board, the Nasdaq proposal provides detailed guidelines to determine whether a director is independent, such as, among other things, certain payments to a charity or not-for-profit organization where the director is an executive officer, former affiliations with the company's outside auditors, interlocking compensation committee memberships, and a greater than 20% share ownership of the company's voting securities.

-- ***Director Compensation:*** Like the NYSE proposal, members of the audit committee will be prohibited from receiving any compensation other than director's fees from the company. Additionally, independent directors (and their family members) will be prohibited from receiving any payments in excess of $60,000 other than for board service.

3) ***NYSE and Nasdaq Proposal Comparison***

In order to more conveniently sort out the similarities and differences between the two exchanges' proposals, we have contrasted the proposals in the table on the following page:

[28] Note that the Nasdaq proposal refers to "all stock option plans" rather than all equity compensation plans, making the requirement somewhat unclear with respect to its applicability to non-option awards (i.e., restricted shares). Our understanding, however, is that the requirement would apply in a manner consistent with that of the NYSE's proposal.

Issue	NYSE	Nasdaq
Shareholder approval of equity compensation plans	Applies to "all" equity compensation plans and any material modifications ▪ "Material modifications" defined	Applies to "all" equity compensation plans and any material modifications ▪ "Material modifications" not defined
Broker votes	Prohibited without shareholder instructions	Silent
Compensation Committee	▪ Board determines independence of directors (no material relationship test) ▪ Charter required	▪ Independent director guidelines proposed ▪ No charter required
Audit Committee Compensation	Limited to director's fees	Limited to director's fees
Disclosure of corporate governance guidelines	Company's website and annual report	Silent
Sarbanes Oxley Provisions	Silent	▪ Prohibitions on executive and officer loans ▪ Accelerated reporting requirements of insider stock transactions

4) ***NYSE and Nasdaq Rule Proposals—Implications***

These proposals, whether adopted in their current form or with slight modification, will give shareholders much more control over the level of potential share dilution attributable to equity compensation plans and enhance corporate governance requirements.

Although there are a number of differences between the NYSE and Nasdaq proposals and different rules may be approved for each market, we anticipate that the final rules approved by the SEC will be relatively similar in scope.

As with any new rule proposal, clarification will be warranted, hopefully by the SEC and both exchanges on their respective proposals. For more detailed information about the NYSE and Nasdaq proposals, including a historical examination of the original proposals and subsequent changes, see our October 15, September 10, July 24, and June 10, 2002 Alert Letters.

3. SEC REQUIREMENTS

As part of its ongoing effort to enhance the transparent disclosure of corporate transactions, the SEC initiated and subsequently adopted a number of rule changes in 2002. They are as follows:

- ***Disclosure Rules for Equity Incentive Plans:***[29] This amendment enhances disclosure of the number of shares to be issued upon exercise of outstanding options, warrants and rights granted to participants in equity incentive plans, as well as the number of securities that remain available for future issuance under these plans, including plans which have not been approved by shareholders. Companies must be in compliance with the new disclosure rules in their Form 10-K filed for fiscal years ending on or after March 15, 2002, and for new proxy statements for shareholder meetings on or after June 15, 2002.

- ***Disclosure of Certain Management Transactions:***[30] In order to conform with the Sarbanes-Oxley Act, this rule requires insiders at pubic companies (i.e., Section 16 "reporting persons") to report transactions involving changes in stock ownership within an accelerated time period, namely by the end of the second business day following the date of the transaction. Two exemptions to the accelerated filing requirements exist: (1) Arrangements entered into pursuant to Exchange Act Rule 10b5-1(c) provided the reporting person does not select the date of execution, and (2) discretionary transactions pursuant to employee benefit plans where the reporting person does not select the date of execution. The deadline for these two exemptions is five business days after the plan administer or broker notifies the insider of the transaction.

4. TAX DEVELOPMENTS

In 2002, the IRS issued two items with executive compensation implications:

- ***Employment Taxes and Withholding Obligations on Employee Stock Purchase Plans and Incentive Stock Options:***

  After debating most of the first half of the year, which included months of public opposition, the Treasury Department and Internal Revenue Service (IRS) through Notice 2002-47 postponed indefinitely the original January 1, 2003 effective date for the imposition of employment taxes (Federal Insurance Contributions Act [FICA] and Federal Unemployment Tax Act [FUTA]) and federal income tax withholding on employee stock purchase plans and incentive stock options.[31] As a result of Notice 2002-47, incentive stock option exercises and purchases under employee stock purchase plans, as well as related share sales, will not be subject to FICA or FUTA taxes or federal income tax withholding until a review of all

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[29] Final Rule: Disclosure of Equity Compensation Plan Information [Release Nos. 33-8048, 34-45189; File No. S7-04-01], December 21, 2001. See also our January 7, 2002 Alert Letter.

[30] Final Rule: Ownership Reports and Trading by Officers, Directors and Principal Security Holders [Release Nos. 34-46421; 35-27563; File No. S7-31-02, August 29, 2002. See also our August 28, 2002 Alert Letter.

[31] See Notice 2002-47, http://www.irs.gov/pub/irs-drop/n-02-47.pdf and our July 1, 2002 Alert Letter.

public comments is completed and future guidance is issued. Even after further guidance is issued, the notice also stated that employers will not be required to implement the changes to their programs for more than two years after any regulations have been issued in final form.

- ***Proposed Regulations on Golden Parachute Payments***

In addition to the above Notice, the IRS also issued guidance on the valuation of stock options under Internal Revenue Code Sections 280G and 4999 relating to transactions in connection with a change in control (CIC). This past summer, the IRS released Revenue Procedure (Rev. Proc.) 2002-45,[32] which clarifies that a stock option will ***not*** be considered properly valued for golden parachute purposes if the option is valued solely using the intrinsic value method (i.e., the spread between the exercise price and the value of the underlying stock, not less than zero) at the time of a CIC. Instead, a stock option will now be considered properly valued if based on any valuation methodology (e.g., Black-Scholes) in accordance with generally accepted accounting principles (such as FAS 123). This new revenue procedure also modified portions of Rev. Proc. 2002-13,[33] which was released earlier in 2002 in conjunction with the newly proposed regulations that apply to golden parachute payments. In Rev. Proc. 2002-13, the IRS provided a safe harbor valuation approach based on a modified Black-Scholes option pricing model as an alternative to the intrinsic value method. Unlike traditional Black-Scholes option pricing models, expected dividends on the underlying stock and the risk-free interest rate over the option term are not considered in the safe harbor calculation. The IRS has, however, indicated that these factors are “included in the table” provided for applying the safe harbor method.

This additional guidance has significant implications for the design of stock option plans in the event of a CIC because the Black-Scholes option value (traditional or safe harbor methods) typically exceeds the intrinsic value of an option. Thus, the use of the Black-Scholes methodology relative to the intrinsic value method would result in unfavorable additional tax liabilities for excess parachute payments. One important issue is that options which are underwater (up to a spread factor of -60%) on the date of the CIC have a positive Black-Scholes value. This could potentially result in a tax payment for an option that may never have value to an employee.

Companies, especially those with tax gross-up provisions, should evaluate the cost of potential tax liabilities in terms of a possible loss of corporate tax deductions, increase in tax gross-up payments and parachute excise taxes paid by its executives. Unfortunately, the alternative option design strategies designed to mitigate the adverse consequences under the new guidance inevitably involve a trade-off between accounting cost, corporate governance principles, retention considerations and post-CIC executive protection. In addition, some strategies should be implemented as soon as possible, because, in many cases, the changes can only apply to new, rather than outstanding, stock option grants. To examine

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[32] See Internal Revenue Bulletin No. 2002-27, July 8, 2002 and our June 30, 2002 Alert Letter.

[33] Rev. Proc. 2002-13, 2002-8 IRB 549, effective April 26, 2002.

possible strategies available to address the new guidance, see our June 30, 2002 Alert Letter.

CONCLUSION

Below, we briefly highlight the implications of the reforms we have referenced throughout this memorandum:

Issue	Regulatory	Investor Groups	Best-Practice Initiatives
Governance	Board compensation committee independence and requirements	Greater board independence and accountability	Consultants reporting directly to independent compensation committee
Disclosure	▪ Accelerated equity transaction filing for insiders ▪ Enhanced disclosure of equity issuances	Transparent compensation disclosure	Greater disclosure of dilution, contracts and executive stock sales
Executive Compensation	▪ Prohibition on executive loans ▪ Increased fines and penalties for non-compliance	▪ Reduced share usage and dilution ▪ Performance oriented	Executive and director ownership for extended periods
Option Expensing	Bias toward expensing options		Uniform option expensing approach
Shareholder Rights	Shareholder approval of stock plans, including material plan amendments	Shareholder approval of stock plans and all material amendments	

Many of the reforms we have referenced have been issued without further official guidance, which makes navigating through the executive compensation reforms more challenging. The prospect of additional reforms in 2003 may enhance this challenge. Accordingly, we encourage you to visit our website frequently to obtain updates and interpretations of any new reform initiatives or guidance on existing ones, so that you may continue to stay on course as you navigate through the complexities of executive compensation reforms.

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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 Justin R. Fossbender 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.

Referenced "Alert" Letters by Date

1) January 7, 2002 – "SEC Adopts New Disclosure Rules for Equity Incentive Plans"
2) January 8, 2002 – "ISS 2002 Policy Changes"
3) January 11, 2002 – "IRS Issues Proposed Regulations on the Taxation of Employee Stock Purchase Plans and Incentive Stock Options"
4) January 28, 2002 – "IRS Extends Comment Period for Proposed Regulations on the Taxation of Employee Stock Purchase Plans and Incentive Stock Options"
5) February 28, 2002 – "No Tax Deduction if No Expense for Stock Options – Part II"
6) March 4, 2002 – "Forces to Overthrow Stock Option Accounting Gaining Strength"
7) April 1, 2002 – "Executive Compensation Year in Review (2001)"
8) June 3, 2002 – "Standard & Poor's Introduces "Core Earnings" Definition That Includes Stock Options as an Expense"
9) June 10, 2002 – "NYSE and NASDAQ Address Compensation-Related Corporate Governance Issues"
10) June 13, 2002 – "ISS Corporate Governance Quotient"
11) June 30, 2002 – "IRS Issues Additional Guidance on Valuation of Stock Options Under the New Proposed Regulations on Golden Parachute Payments"
12) July 1, 2002 – "Treasury Department and IRS Extend Moratorium Related to the Imposition of Employment Taxes and Withholding Obligations on Employee Stock Purchase Plans and Incentive Stock Options"
13) July 24, 2002 – "Planning for the New Shareholder-Approval Requirements for All Equity Grants to Employees"
14) July 30, 2002 – "Update on Stock Option Accounting Debate"
15) August 2, 2002 – "EITF Finally Concludes Deliberations on Issue No. 00-23"
16) August 9, 2002 – "Executive Compensation Implications of the Sarbanes-Oxley Act of 2002"

17) August 28, 2002 – “SEC Finalizes Rules on Ownership Reports and Trading by Officers, Directors and Principal Security Holders”

18) August 29, 2002 – “SEC Adopts Rules on Accelerated Filing Deadlines for Quarterly and Annual Reports”

19) September 10, 2002 – “NYSE and NASDAQ Governance Rule Proposals Under Review at SEC”

20) October 9, 2002 – “Conference Board Issues Executive Compensation Best Practice Suggestions”

21) October 11, 2002 – “FASB Releases Exposure Draft on Amendments to Statement 123”

22) October 15, 2002 – “Update on NYSE and NASDAQ Shareholder Approval Requirements”

23) December 23, 2002 – “FASB Releases Invitation to Comment on IASB Share-based Payment Exposure Draft”