

February 28, 1997

**SUMMARY OF 1996 LEGISLATIVE AND
RELATED DEVELOPMENTS
AFFECTING EXECUTIVE COMPENSATION**

This letter summarizes legislative and related developments affecting executive compensation during 1996. The footnotes following each section heading refer to our earlier letters which address these issues with greater specificity.¹ The most prominent regulatory activities affecting executive compensation during 1996 were the changes made by the Securities and Exchange Commission (SEC) to Rule 16b-3, which exempts certain stock-based compensation transactions by insiders from short-swing profit recovery. It is expected that further interpretations of this new rule will continue throughout 1997.

SECURITIES EXCHANGE COMMISSION (SEC)²

The SEC adopted new Rule 16b-3 (New Rule) effective November 1, 1996. The New Rule will simplify compliance and make it much easier for companies to exempt most stock-based compensation transactions between a company and its insiders from the reach of short-swing profit recovery. The New Rule provides that *transactions* meeting the requirements specified within four broad categories established by the SEC will be exempt. The former approach provided protection based, in part, on appropriate stock *plan language* and *approval by shareholders*.

There are four categories under which a transaction may find exemptive relief under the New Rule.

1. Plans that comply with or mirror Internal Revenue Code (IRC) or ERISA requirements, such as “Tax Qualified Retirement Plans,” “Excess Benefit Plans,” and “Stock Purchase Plans”.
2. Acquisitions of stock-based awards upon the occurrence of one of the following conditions:
 - A) Proper approval of the transaction by the board of directors, a committee, or shareholders
 - B) Six-month holding period between the acquisition and disposition of the grant
3. Dispositions of stock to the company by an insider are deemed exempt, provided that the transaction is approved by the full board, a committee of non-employee directors or shareholders. Examples of a disposition are: cash settlements of stock-based awards; shares withheld to cover taxes; and stock tendered to exercise stock options.

¹ A copy of these letters may be requested by phone from any of our offices or accessed through our web site @ fredericwcook.com

²Alert letter, *SEC Adopts a Radically Different Rule 16b-3*, August 2, 1996

4. The fourth category provides exemptive relief for a very narrow range of volitional or “discretionary transactions”. A discretionary transaction occurs when:

A) Monies are switched into or out of a company’s multiple stock-based fund or

B) Cash withdrawals are made from a company’s multiple stock-based fund

The requirement of obtaining shareholder approval of stock compensation plans for 16b-3 exemption purposes has been eliminated under the New Rule. The likelihood of companies immediately abandoning prior practice, however, is expected to be very limited as consideration must be given to other requirements which require approval by shareholders, such as: the million dollar deductibility limit under Internal Revenue Code Section 162(m); incentive stock option rules; state corporation laws; and rules governing the listing of shares on stock exchanges.

TRANSFERABLE OPTIONS³

Companies may add estate planning features to their stock option plans under the New Rule as the right to transfer a stock option to a family member is no longer prohibited. The advantage of this feature is the opportunity the executive has to reduce estate taxes.

Studies prepared by the National Association of Stock Plan Professionals on transferable options estimate that this new feature can as much as triple the amount received by heirs, compared to an executive exercising and subsequently holding the shares or retaining the option until death. Income taxes remain collectible from the executive at the time of exercise (no income taxes are due at the time of option grant or at its transfer, however, the transfer will be subject to gift taxes).

A few areas which remain unclear in transferring options are the gift and estate tax consequences when an unvested option is transferred and how to file the appropriate registration for securities obtained by the recipient. The key issues to be considered upon a decision to incorporate option transferability to a stock option grant include:

1. Number of executives eligible - There is no cost to the company in offering this feature but the executive must be prepared to cover the required tax at the time the recipient chooses to exercise the options. As the executive would need quick access to cash flow to cover the tax, the utilization of this feature may be better suited initially by only the highest paid executives.
2. Transfer eligible recipients - It is reasonable to limit option transferability solely to immediate family members. This retains the linkage between the character of the option as an incentive award under the presumption that the executive is as interested in maximizing their families’ wealth as their own.
3. Required disclosure - Upon the transfer of an option by an executive named in the company’s proxy statement, a company could report the transferred option in the outstanding options table as a separate line item with an appropriate explanation in a footnote.

³ Alert letter, *Transferable Stock Options - After New Rule 16b-3*, October 7, 1996.

STOCK OPTION ACCOUNTING

There were four regulatory accounts in 1996 that may have potential impact on the accounting and reporting methods for stock-based awards: (1) the earnings impact for all stock-based awards are required to be disclosed in a pro-forma financial footnote; (2) additional interpretations on accounting for stock options; (3) changes in financial statement reporting and calculating of earnings per share and finally; (4) the use of non-recourse loans in exercising stock options.

Disclosure of stock compensation costs⁴ - The Financial Accounting Standards Board (FASB) established new provisions under FAS 123 requiring “general disclosure” in a footnote for the cost of stock-based awards beginning with the 1996 financial statements. “Pro-forma” disclosure under FAS 123 is required if a company continues to recognize expense for stock-based awards under the provisions of Accounting Principles Board’s Opinion 25.

“General disclosure” requires a description of stock-based compensation plans and award terms, including the number of shares authorized, the maximum option term, and the vesting conditions. A table providing specific stock option and stock-based award activity and balances for each year is also a required under the disclosure rules.

The provisions for “pro-forma” expense disclosure calculate what net income and earnings per share would have been had the company accounted for its stock-based awards under the provisions of FAS 123. In addition to computing the “fair value” of awards granted during the year, as determined under the general disclosure rules, the pro-forma income statement requires companies to also recalculate compensation cost for all awards granted after 1994 using the special valuation provisions of FAS 123, including provisions with respect to vesting, forfeitures, modifications, settlements, and broad-based stock purchase plans.

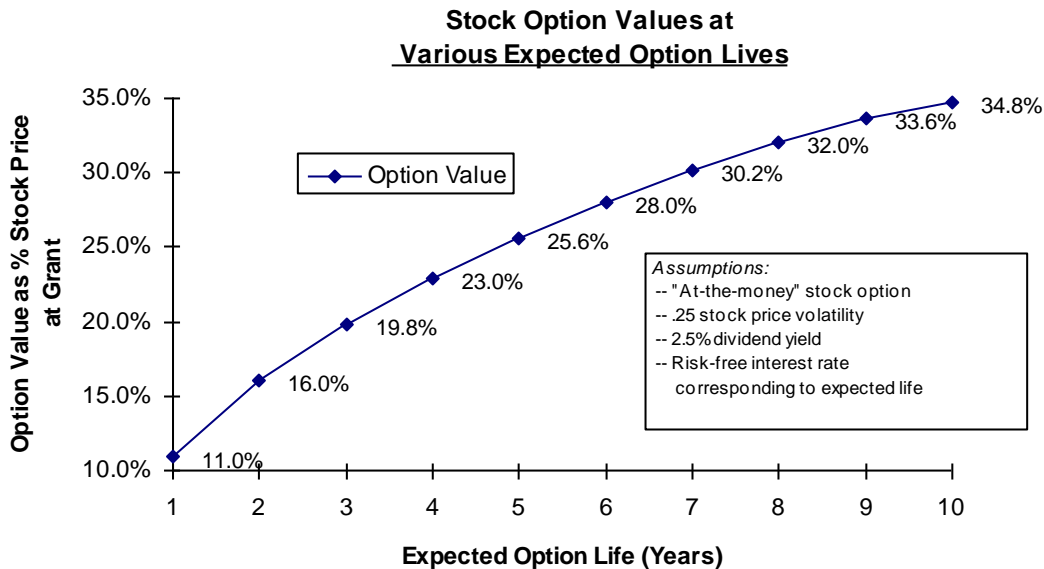
One of the methods that may be used to calculate the cost for stock-option compensation is the Black-Scholes model. A significant variable is the “expected life of the option,” because the other Black-Scholes variables, i.e., volatility, dividend, and risk-free interest rate assumptions, are generally dependent on the expected life.

As with all accounting standards, the footnote disclosure provisions are required only for “material items” but there is currently no established “bright-line” test for determining materiality. However, companies are expected to perform a “ball park” calculation to support whether disclosure is in fact immaterial.

Even though the majority of companies will disclose for the first time under the new provision in the 1996 annual report, we identified nine companies which disclosed under the new provision in their 1995 annual report. The expected option terms for these companies ranged from 3 to 7.5 years, with a median of 5 years. The Black-Scholes values calculated ranged from 17 percent to 49 percent of option price with median value of 31 percent.

⁴ Alert letter, *Compliance With The Footnote Disclosure Requirements Of FAS 123*, March 20, 1996

The following chart illustrates how the fair value of a stock option varies using different expected life assumptions:



Financial Accounting Under Opinion 25⁵ - A number of issues have accumulated over the years on how Opinion 25 should be applied to evolving forms of grants and practices. Therefore, the FASB decided in 1996 to add interpretations to its agenda on issues such as: (1) accounting for grants to outside directors, (2) the effects of dividends on restricted stock, and (3) accounting for dividends on restricted stock awards.

Earnings Per Share⁶ - For the 1997 calendar year financial statements, FASB seems to have reached a conclusion on the required earnings per share disclosure. Public companies with outstanding stock options and other stock-based awards will be required to compute and disclose two forms of EPS for both income from continuing operations and net income on the face of the income statement.

The first type of disclosure is referred to as “basic” EPS which does not reflect the potential dilution from outstanding stock-option awards. The second, “diluted” EPS is essentially the same as “fully diluted” EPS under current disclosure rules with a few alternations. “Basic” EPS is most simply described as net income divided by weighted average total common shares outstanding. “Diluted” EPS is net income divided by the weighted average total common shares outstanding plus the dilutive effect of all stock options using the treasury stock method, other stock-based awards, and potentially dilutive securities at year end.

⁵ Alert letter, *FASB Approves “Repairs and Maintenance” Project On Opinion 25 - Accounting For Stock Issued To Employees*, August 26, 1996 and 1/10/97

⁶ Alert letter, *FASB Proposes Changes in Calculation and Presentation of Earnings Per Share*, April 24, 1996

Exercising Options with Non-Recourse Loans⁷ - The Emerging Issues Task Force addressed several issues on employee stock options accompanied by a “non-recourse” note (secured by the stock) equal to the option price. The issues addressed were (1) the exercise of options with a non-recourse note and the circumstances triggering a new measurement date, (2) terms of interest accrued or paid on the note, and (3) the effect of dividends on stock purchased with a non-recourse note.

FICA ON DEFERRED COMPENSATION⁸

The IRS released proposed regulations that specify that the FICA tax on non-qualified “defined-benefit” arrangements, such as “supplemental” or “excess” pension plans, is not payable until the amount of benefits can be reasonably determined. FICA tax is generally imposed at the time remuneration is earned (“actually or constructively paid”). Most non-qualified deferred compensation is fully vested, i.e., not subject to risk of forfeiture and therefore FICA tax is generally imposed at the time of deferral.

The following is a brief summary of when selected benefits are subject to FICA.

Type of Benefit	Benefit Subject to FICA Tax When.....	
	Actually or Constructively Paid	Earned or Not Subject to Risk of Forfeiture
• Deferred Annual Compensation <i>denominated in Cash</i>		X
• Deferred Annual Compensation <i>denominated in Stock</i>		X
• Stock options and SARs	X	
• Restricted stock and performance shares	X	
• Restricted stock units and performance share units		X
• ERISA excess benefit plans and supplemental executive retirement plans		X
• Excess parachute payments	X	

FDIC GOLDEN PARACHUTE LIMITS⁹

The Federal Deposit Insurance Corporation (FDIC) issued its final rule in April 1996, “The Regulation of Golden Parachutes and Other Benefits Which May Be Subject to Misuse” which limits the golden parachute payment amount that any FDIC-insured institutions can pay to an employee. Golden parachute payments is basically defined as the payments contingent upon termination of employment made to either an employee, director or major shareholder of a financial institution.

The Rule does not allow an institution or holding company to make golden parachute payments, large accelerated payment, if it is or will shortly become insolvent or is designated as a troubled

⁷ Alert letter, *The Use of Non-Recourse Loans to Exercise Stock Options Can Cause Variable Expense*, May 6, 1996

⁸ Alert letter, *IRS Provides Guidance On FICA Treatment For Deferred Compensation*, February 14, 1996

⁹ Alert letter, *FDIC Rule Limits Golden Parachute And Indemnification Payments At Insured Financial Institutions*, April 30, 1996

institution. The types of payments which cannot be made include (1) direct payments, (2) forgiveness of debt, (3) benefits such as stock options, (4) any segregation of funds in a trust, and (5) reimbursement of penalties and legal fees to any employee who has violated banking laws.

The types of payments allowed within the Rule include (1) qualified retirement plans, (2) bona fide deferred compensation plans, (3) nondiscriminatory severance pay plans, and (4) other types of common benefit plans and death benefits.

This letter is intended to be a brief summary of some of the key developments affecting executive compensation during 1996. Please refer to the alert letters referred to in the footnotes as well as the following summary for more detailed discussions on these points. Additional information may be obtained by contacting Lori Roth or any other member located in Chicago (312) 332-0910, New York (212) 986-6330, or Los Angeles (310) 277-5070. Specific questions regarding a company situation should be addressed to legal counsel or accounting staff.

1996 “Alert” Letters

Sorted by Date

<p>IRS Provides Guidance On FICA Treatment For Deferred Compensation <i>February 14, 1996</i></p>	<p>The Use of Non-Recourse Loans To Exercise Stock Options Can Cause Variable Expense <i>May 6, 1996</i></p>
<p>“Fairness To Employees Requires That Shareholders Accept More Dilution From Stock Options” <i>March 15, 1996</i></p>	<p>New SEC Rule 16b-3 Eliminates Requirement For Shareholder Approval Of Executive Stock Plans <i>July 3, 1996</i></p>
<p>Compliance With The Footnote Disclosure Requirements Of FAS 123 <i>March 20, 1996</i></p>	<p>SEC Adopts A Radically Different Rule 16b-3 <i>August 2, 1996</i></p>
<p>FASB Proposes Changes In Calculation And Presentation Of Earnings Per Share <i>April 24, 1996</i></p>	<p>FASB Approves “Repairs and Maintenance” Project On Opinion 25 –Accounting For Stock Issued To Employees <i>August 26, 1996</i></p>
<p>FDIC Rule Limits Golden Parachute And Indemnification Payments At Insured Financial Institutions <i>April 30, 1996</i></p>	<p>Transferable Stock Options - After New Rule 16b-3 <i>October 7, 1996</i></p>

Three Year Index of Selected Alert Letters

Sorted by Subject

Directors' Pay

- 12/26/95 Regulatory Implications of Deferred Stock Plans for Directors
- 12/22/95 Terminating Non-Employee Directors' Retirement Plans
- 07/12/95 How Should Corporate Directors be Paid? -- NACD Presents its Views

Executive Compensation - Other

- 03/15/96 "Fairness to Employees Requires that Shareholders Accept More Dilution from Stock Options"
- 10/04/94 Let Companies Fund Executive Pensions

FASB - Stock Based Accounting

- 08/26/96 FASB Approves "Repairs and Maintenance" Project on Opinion 25 -- Accounting for Stock issued to Employees
- 05/06/96 The Use of Non-Recourse Loans to Exercise Stock Options Can Cause Variable Expense
- 03/20/96 Compliance with the Footnote Disclosure Requirements of FASB 123
- 11/08/95 FASB Releases Final Standard on Accounting for Stock-Based Compensation
- 05/26/95 FASB Released Draft of Final Standard on Accounting for Stock-based Compensation
- 03/09/95 FASB Tentatively Sets Effective Date and Disclosure Requirements for Stock Options Under New Accounting Standard
- 01/18/95 FASB Reconsiders Methodology for Valuing Employee Stock Options and Other Equity Grants

FASB - Earnings Per Share

- 04/24/96 FASB Proposes Changes in Calculation and Presentation of Earnings Per Share

Institutional Shareholders

- 03/23/94 Institutional Investor Publicized Voting Guidelines

SEC - Disclosure

- 07/21/95 SEC Proposes Narrowing Proxy Statement Disclosure of Executive Compensation & Expanding Director Compensation Disclosure

SEC - Section 16

- 10/07/96 Transferable Stock Options - After New Rule 16b-3
- 08/02/96 SEC Adopts a Radically Different Rule 16b-3
- 07/03/96 New SEC Rule 16b-3 Eliminates Requirement For Shareholder Approval Of Executive Stock Plans
- 11/03/95 SEC Re-Proposes Rule 16b-3 Changes Which Would Vastly Simplify Compliance

SEC - Other

- 01/10/94 SEC Eliminates Preliminary Proxy Statement Filing for any Employee Plan Voting Matter

Tax - 162(m)

- 06/13/94 \$1 Million Compensation Deduction Limitation Update
- 06/01/94 1994 Proxy Disclosure of IRC Section 162(m) Policy, Incentive Plan Approval and Option Valuation

Tax - Other

- 04/30/96 FDIC Rule Limits Golden Parachute and Indemnification Payments at Insured Financial Institutions
- 02/14/96 IRS Provides Guidance on FICA Treatment for Deferred Compensation

A copy of these letters may be requested by phone from any of our offices or accessed through our web site @ fredericwcook.com.