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New York • Chicago • Los Angeles

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Summary of 1998 Legislative and Other Developments Affecting Executive Compensation

This letter summarizes the significant developments affecting executive compensation during 1998. The footnotes to each section heading refer to our letters released during the year that address these issues in greater detail.

The most significant development was the completion of the Financial Accounting Standards Board's (FASB) Opinion 25 Interpretation project, which sought to clarify issues relating to the accounting treatment for employee equity incentives that have arisen since Accounting Principles Board (APB) Opinion 25 was first adopted in 1972. Other developments include Internal Revenue Service (IRS) guidance with regard to the timing and valuation of transferred stock options, and the Securities and Exchange Commission's (SEC) proposal to allow certain recipients of transferred options to rely on a company's Form S-8 for registration purposes. In addition, the New York Stock Exchange (NYSE) clarified the definition of "broad-based" stock plans that are exempt from shareholder approval, although this issue is still under consideration.

STOCK PLAN ACCOUNTING ISSUES

Opinion 25 Interpretation Project[1]

The purpose of the Opinion 25 Interpretation project, which concluded its first phase on December 4th, was to address 13 practice issues that have accumulated during the past 26 years relating to expense recognition for stock-based compensation. These issues, which resulted from the increase in the design variations of stock incentive plans and the increased use of equity compensation, were not addressed during the FASB's decade-long project on accounting for stock-based compensation, which led to the issuance of FAS Statement 123. The issues were not addressed because the intent of the FAS Statement 123 project was to change the accounting standards for stock issued to employees. Had the FASB mandated the adoption of FAS 123 for expense recognition, many of the APB 25 practice issues would have been resolved.

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[1] Alert Letters: *FASB Makes Progress on Interpreting Opinion 25 Accounting Rules on Employee Stock Options*, June 9, 1998; *Update on FASB Opinion 25 Stock Compensation Project*, August 5, 1998; *FASB Proposes Charge to Earnings for Repriced Stock Options*, August 28, 1998; *FASB Completes Opinion 25 Interpretation Project – Exposure Draft to Be Issued in March*, December 18, 1998

In conducting this project, the FASB's intent was strictly to interpret issues within the context of the Opinion, not to rewrite the accounting standard. Consequently, the measurement date and intrinsic value principles inherent in Opinion 25 were not changed. The most important changes proposed by the FASB are:

1. Stock options granted to non-employee directors (and other non-employee service providers such as leased employees, consultants and independent contractors) will require a charge to earnings equal to the options' "fair value" at vesting

2. Repriced stock options will be treated as variable grants involving a charge to earnings for option gains at exercise

3. Companies will be able to issue stock in subsidiaries to subsidiary employees, subject to repurchase rights, and treat the grants as fixed grants under Opinion 25 in certain circumstances

4. Discretionary modifications to outstanding grants that enhance the "fair value" of the grants to employees may involve a new measurement date and additional compensation expense under certain circumstances

An Exposure Draft is expected during March 1999 and will be followed by a three-month public comment period. The final Interpretation, which is expected in September 1999, will apply to financial statements issued after its release. While the Interpretation applies to all transactions that occur after December 15, 1998, it will not be applied retroactively to financial statements issued prior to the final Interpretation. To assist companies with understanding the impact of the Interpretation on transactions that occur during the transition period, the FASB staff has developed six examples of the transition provisions. These examples, along with a summary of the proposed Interpretation, can be accessed via FASB's web site, www.fasb.org.

Accounting for Deferred Compensation Held in Rabbi Trusts[2]

As expected, the Emerging Issues Task Force's (EITF) ruling on the accounting for deferred compensation held in rabbi trusts is consistent with the accounting treatment for stock awards that are settled in cash under APB Opinion 25. The EITF ruled that deferred stock compensation held in rabbi trusts must be paid out in shares of company stock to avoid a charge to earnings for the growth in stock price during the deferral period. So long as the deferred stock balance cannot be diversified and is settled in stock, compensation expense is equal to the value of the stock at the time of deferral. However, if the stock balance is diversified or can be paid out in cash, then the company must recognize additional compensation for the increase in value during the deferral period. This ruling on Issue No. 97-14, *Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested*, became effective on March 19,1998.

[2] Alert Letter*, FASB'S EITF Shuts Down Use of Rabbi Trusts by Companies to Diversify Deferred Stock Into Other Investments and to Pay Out in Cash Without an Earnings Charge*, September 18, 1998

The EITF provided transitional guidance to companies with deferred stock balances held in rabbi trusts that pay out in cash or permit diversification and to companies that have previously diversified stock held in the rabbi trusts.

It should be noted that EITF 97-14 may be applicable to deferred stock accounts not held in rabbi trusts. Consequently, companies that permit diversification or payout in cash should consider amending their plans to avoid potential earnings charges.

EPS Effect of Deferred Stock[3]

The EITF concluded that the treatment of deferred stock for FAS 128 earnings per share (EPS) calculations depends upon how the account will be settled at the end of the deferral period. If a deferred stock balance must be paid out in actual shares, then such shares should be included in shares outstanding for both Basic and Diluted EPS purposes during the deferral period. However, if the deferred stock obligation may be settled in actual shares or cash, then the change in the value of those shares would affect both Basic and Diluted EPS (by affecting net income), but the shares would not be included in either Basic or Diluted EPS.

TRANSFERABLE OPTION DEVELOPMENTS

Taxation Issues[4]

In 1996, the SEC amended Rule16b-3 to permit executives to transfer nonqualified options without being subjected to short-swing profit provisions of Section 16(b) of the 1934 Act. The transferability feature provides a potential tax benefit as it allows executives to remove assets from their taxable estate. In the absence of direction from the IRS, executives have been transferring options when there is little appreciation in stock price, e.g., soon after grant and prior to vesting, and have been employing valuation methodologies that result in the lowest possible value in order to maximize their tax benefit. On April 13th, the IRS provided guidance on the transfer of unvested options and the valuation of executive stock options transferred for estate tax planning purposes.

Revenue Ruling 98-21 states that a transfer of an unvested option is not a completed gift. This implies that options cannot be transferred until vesting occurs, at which time the value of the gift can be determined for tax purposes. Since this ruling delays the valuation date, the tax benefit to executives can decrease if the stock price rises during the vesting period.

With respect to valuation, IRS *Revenue Ruling 98-24* sets forth an acceptable valuation methodology for transferred options, which ensures that the option is valued at a "fair value" rather than the lowest value. Specifically, the ruling states that the option should be valued using an option pricing model, such as Black-Scholes. The model should use either the maximum term of the option or the expected term of the option that is used for FAS 123 footnote disclosure in

[3] Alert Letter, *FASB'S EITF Shuts Down Use of Rabbi Trusts by Companies to Diversify Deferred Stock Into Other Investments and to Pay Out in Cash Without an Earnings Charge*, September 18, 1998
[4] Alert Letter, *Transferable Option Developments – IRS Rules on Transferring Unvested Options*, April 17, 1998.

the granting company's annual report for the year of grant. Additionally, the option value should not be reduced to reflect illiquidity or lack of further transferability.

SEC Issues[5]

The SEC's proposal to allow certain family members to rely on the company's Form S-8 for registration purposes enhances the attractiveness of transferring stock options by removing one of the administrative complexities for the transferee. Under the current rules, Form S-8 registration, a simplified registration form designed specifically for shares offered to employees for compensatory purposes, is not available once the option is transferred. Therefore, in order to exercise the option and sell the underlying shares, transferees must either file a Form S-3 registration or rely on the one-year holding period under Rule 144 (restricted securities).

The proposed amendment clearly defines the circumstances under which Form S-8 registration can be used for transferred options, e.g., gifts to immediate family, trusts or other entities for family benefit or as part of a divorce settlement. The proposal reaffirms that Form S-8 registration can be filed at any time prior to exercise of the affected stock options.

The SEC also proposed changes to the proxy statement disclosure for transferred options. Specifically, options transferred in the year of grant must be shown in both the summary compensation table and the options/SAR grant table. As proposed, the transferred options would not need to be included in the second option table, which shows the gains realized from stock options exercised by executive officers, as well as gains on stock options held by those individuals at year end.

The SEC has also asked for comments on several related issues, e.g., should Form S-8 be extended to options transferred for consideration and is the proposed disclosure of transferred options in the proxy statement adequate.

SECTION 162(m) REVISITED[6]

While there were no new developments relating to the deductibility of compensation under Internal Revenue Code Section 162(m) during 1998, five years have passed since Section 162(m) regulations first went into effect. This passage of time is important because the tax code stipulates that incentive plans that allow the compensation committee to establish goals need to be approved by shareholders at least every five years in order to maintain the tax deductibility of performance-based compensation in excess of $1 million.

Consequently, plans approved in 1994, which have not been subsequently taken back to shareholders, should be re-approved by shareholders in 1999. Unless incentive payouts are determined by formula, shareholders should be asked to re-approve performance measures and individual grant or payout limits.

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[5] Alert Letter, *SEC Proposes Extending Form S-8 Registration to Transferred Stock Options*, March 30, 1998.
[6] Alert Letter, *A Reminder to Executive Compensation Professionals: Help Your Company Preserve the Tax Deductibility of Executive Compensation*, October 20, 1998

Companies that have recently had an initial public offering are reminded that shareholder approval of performance-based compensation plans is needed within three full calendar years of the IPO to preserve the performance-based exemption, which means that 1995 IPO companies must submit their plans for approval in the 1999 proxy. Spin-offs from public companies must seek shareholder approval after the first full fiscal year following the transaction.

NYSE ADDRESSES BROAD-BASED STOCK OPTION EXEMPTIONS[7]

The New York Stock Exchange (NYSE) generally requires that listed companies obtain shareholder approval for stock option, stock purchase, and other plans under which directors and officers may acquire company stock. However, the shareholder approval requirement is waived under certain circumstances, including if the plan is deemed to be "broadly-based."

The current definition of broadly-based was formally clarified by the NYSE and adopted following SEC approval in April. It requires that at least 20% of employees be eligible to participate in the plan and that no more than 50% of such persons be officers or directors.

Since approval, the rule has been criticized as offering companies a loophole to avoid shareholder approval. In response, the NYSE formed a task force to reconsider the definition of broadly-based and solicit public opinion. On October 1st, the NYSE approved a new definition and submitted it to the SEC for review. Under the new proposal, a plan is broadly-based if:

- At least a majority of the issuer's full-time, exempt U.S. employees are eligible to participate in the plan, and

- A majority of the shares awarded under the plan (or shares of stock underlying options awarded under the plan) are made available to employees who are not officers or directors

The revised definition, while tightening the requirements, is still being criticized by some institutions as too loose. As a result, it is not clear when and if the revision will become effective, which means that the 20% standard adopted in April will remain in effect for the time being.

To address concerns from institutional investors regarding potential dilution from plans, the NYSE formed a task force to study the feasibility of a new listing standard that would limit the aggregate dilution from non-shareholder approved stock plans. The task force is charged with developing a methodology for measuring dilution and addressing the practical implications of implementing a cap. We expect that dilution will either be measured using a "run-rate" approach, which is based on annual share usage, or an "overhang" approach, which measures the cumulative impact of outstanding stock awards and those reserved for future issuance. While the task force has not completed its study, we favor the run-rate approach since the measure reflects a company's intent with regard to dilution, and is unaffected by variables that are outside of the

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[7] Alert Letters: *NYSE Clarifies "Broad-Based" Stock Option Plan Exemption From Shareholder Approval Requirements*, May 6, 1998; *New York Stock Exchange Readdresses the Shareholder Approval Exemption for Broadly-Based Plans*, October 22, 1998.

company's control. The task force is expected to complete this project during 1999 and present its recommendations to the NYSE Board for approval prior to the year 2000 proxy season.

STOCK PLAN DILUTION AND VOTING RESULTS[8]

Potential dilution from stock plans remains a hot topic among investors. However, an Investor Responsibility Research Corporation (IRRC) report published in April indicated that opposition to stock plans requesting more than 10% of shares for new plans is decreasing. We believe that this decrease may be a result of several factors, including clearer descriptions of how the stock will be used, greater use of stock buy-back plans to offset EPS dilution and, perhaps, recognition that including more employees in stock-based compensation programs may have a positive impact on shareholder returns.

The study found that total potential dilution from stock plans among the S&P Super 1,500 averaged 11.6%. Potential dilution among the S&P 500 companies averages 10.0%, but is significantly higher among the small cap companies (13.8%).

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Please refer to the alert letters referenced in the footnotes and the following summary for more detail on the topics summarized below. Additional information can be obtained by contacting Erin Bass-Goldberg in the New York office at (212) 986-6330 or any other member of the firm. This letter and other published materials are available on our web site, www.fwcook.com.

[8] Alert Letter, *Stock Plan Dilution and Negative Shareholder Votes*, July 8, 1998

1998 "Alert" Letters
Sorted by Date

SEC Proposes Extending Form S-8 Registration to Transferred Stock Options 3/30/98	**FASB Proposes Charge to Earnings for Repriced Stock Options** 8/28/98
Transferable Option Developments – IRS Rules on Transferring Unvested Options 4/17/98	**FASB's EITF Shuts Down Use of Rabbi Trusts by Companies To Diversify Deferred Stock Into Other Investments and To Pay Out in Cash Without an Earnings Charge** 9/18/98
NYSE Clarifies "Broad-Based" Stock Option Plan Exemption From Shareholder-Approval Requirements 5/6/98	**A Reminder to Executive Compensation Professional: Help Your Company Preserve the Deductibility of Executive Compensation** 10/20/98
FASB Makes Progress on Interpreting Opinion 25 Accounting Rules on Employee Stock Options 6/9/98	**New York Stock Exchange Readdresses the Shareholder Approval Exemption for Broadly-Based Plans** 10/22/98
Stock Plan Dilution and Negative Shareholder Votes 7/8/98	**ISSue Compass Model** 11/24/98
Update on FASB Opinion 25 Stock Compensation Project 8/5/98	**FASB Completes Opinion 25 Interpretation Project – Exposure Draft to be Issued in March** 12/18/98