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New York • Chicago • Los Angeles

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**Summary of 1999 Legislative and Other  
Developments Affecting Executive  
Compensation**

This letter summarizes the significant developments affecting executive compensation during 1999. The footnotes to each section heading refer to our letters released during the year that address these issues in greater depth.

The year's most significant development was the conclusion of the redeliberation process involved in the Financial Accounting Standards Board's (FASB) interpretation of Accounting Principles Board Opinion No. 25 (APB 25). This process concludes the draft phases of the FASB's interpretation project on issues relating to expense recognition for stock-based compensation. The other regulatory activities affecting executive compensation in 1999 were the actions undertaken by the Securities and Exchange Commission (SEC) to permit votes on shareholder proposals requiring shareholder approval for stock option repricings and to approve the New York Stock Exchange's (NYSE) formal definition for "broad-based" stock plans that are exempt from shareholder approval.

**STOCK PLAN ACCOUNTING ISSUES**

**Completion of Opinion 25 Interpretation Project<sup>1</sup>**

The Opinion 25 Interpretation project was conducted to provide guidance on issues relating to the accounting treatment for employee equity incentives where diversity of application and practice had evolved since the Opinion's adoption in 1972. Through the course of this process, the FASB's intent was strictly to interpret issues within the context of the Opinion. Consequently, the measurement date and intrinsic value principles inherent in Opinion 25 were not changed. The following discussion summarizes the most important decisions reached by the FASB.

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<sup>1</sup> Alert Letters: *FASB Proposes to Tighten the Rules on Stock-for-Tax Withholding*, March 10, 1999; *EITF Requires Compensation Cost for Excess Stock-for-Tax Withholding Transactions*, April 5, 1999; *FASB Releases Exposure Draft on Proposed Interpretation of Opinion 25*, April 27, 1999; *FASB Begins Redeliberations on Proposed Interpretation of Opinion 25*, August 20, 1999; *FASB Redeliberations Continue on Proposed Interpretation of Opinion 25*, November 18, 1999; *FASB Concludes Redeliberations on Proposed Interpretation of Opinion 25*, January 24, 2000

Scope of Opinion 25 – the FASB maintains that the scope of Opinion 25 will not apply to independent contractors and service providers who are not employees. However, in response to negative public comment, the FASB has reversed its proposed position and concluded that stock-based awards granted to outside directors will continue to fall under the scope of Opinion 25.

Stock Option Repricings and Cancellation/Reissuance – the FASB has reaffirmed that variable accounting will apply to stock options that have been repriced. This ruling also applies to synthetic repricings (cancellation/reissue) if either the new options are reissued at a lower price within six months of the cancellation date, or if the options are repriced at a lower price outside the six-month period and the company undertakes one of two actions. These actions include either compensating the employee for the stock price appreciation during the period between cancellation and reissue, or establishing an agreement between the company and the employee to cancel the option.

Excess Stock-for-Tax Withholding – the FASB’s position allows for stock-for-tax withholding only up to the minimum required federal, state, and (presumably) FICA rates. Consequently, actual excess withholding will result in a new measurement date for the entire award (i.e., compensation cost will equal the total intrinsic value of the award as of the excess withholding date). The FASB also identified two circumstances in which variable award accounting will apply prior to an actual excess withholding event. In the first case, variable accounting applies where plans leave the excess withholding election to the sole discretion of the employee. In the second instance, where plans are silent on excess stock-for-tax withholding, variable accounting applies if the company exhibits a pattern of consistently approving excess withholding transactions.

Reload Options – under the new interpretation, the FASB has decided that variable accounting applies to stock options that have been modified to include a “reload” feature. This decision also applies to subsequent reload options (i.e., reloads on the reload) that contain a “reload” feature. However, variable accounting will not be applied in cases where reload provisions are granted with the original options.

Extension of Option Terms – the FASB has concluded that a new measurement date is required for modifications that extend a stock option’s exercise term. Where such a modification involves extending the maximum contractual term beyond the term defined in the original agreement, the new measurement date will be the modification date and compensation cost will be recognized at that time. In the case of post-termination extensions, the compensation cost will also be measured on the modification date, but cost will be recognized only if, and when, a termination actually occurs.

Acceleration of Vesting – acceleration of vesting according to original terms of an option agreement will not require a new measurement date. However, the FASB has decided that, in cases where existing grants are modified to provide for accelerated vesting, a new measurement date will be in effect at that time and compensation cost will be recognized only if, and when, the acceleration event occurs.

Consolidated Financial Reporting – the FASB has decided that Opinion 25 applies as a “two-way street” to all stock-based awards granted within a consolidated group, covering grants made by any one group member to any other member. However, Opinion 25 does not apply to grants made to employees outside of the consolidated group. In contrast, the FASB has decided that the application of Opinion 25 follows only a “one-way” street in the *separate* financial statements of a consolidated subsidiary. The FASB affirmed that, in these cases, parent-company stock grants to subsidiary employees will be accounted for under Opinion 25, while grants of a consolidated subsidiary’s stock to parent-company employees will fall outside the scope. Grants falling outside the scope of Opinion 25 would entail compensation cost equal to the award’s “fair value”.

Effective Date – regardless of when the final interpretation is released, the FASB has concluded that it will be effective July 1, 2000 and will be applied on a prospective basis to all grants, modifications, etc., occurring on or after that date. There are however, two important exceptions. The new rules apply (beginning July 1, 2000) to stock option repricings (or cancellation/reissues) and grants or modifications of awards to non-employees that occurred subsequent to December 15, 1998. The second exception is that the new rules apply (beginning July 1, 2000) to options that are modified to include a “reload” feature after January 12, 2000.

## **SEC ISSUES**

### **SEC Approval of NYSE Definition of Broad-Based Stock Plans<sup>2</sup>**

The New York Stock Exchange (NYSE) generally requires listed companies to 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 cases where the plan is deemed to be “broadly-based.”

The NYSE had previously approved a loose definition of “broadly-based”, which held a plan exempt from shareholder approval requirements if at least 20% of employees were eligible to participate in the plan, and no more than 50% of such persons were officers or directors. In response to criticism that this definition provided companies with a loophole to avoid shareholder approval, the NYSE formed a task force to reconsider the definition of “broadly-based” and solicit public opinion. On October 1, 1998, the NYSE submitted a new definition that was approved by the SEC on June 4, 1999. Under the new definition, a plan is deemed “broadly-based” if:

1. at least a majority of the issuer’s full-time, exempt U.S. employees are eligible to participate in the plan; and
2. 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 NYSE has set the measurement period for testing compliance with the definition as the shorter of three years or the plan’s duration. The test for executive- or officer-status includes the

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<sup>2</sup> Alert Letter: *SEC Approves Revised New York Stock Exchange Definition of Broadly-Based Plan*, June 14, 1998

positions of president, top financial officer, vice president or any and all other policy-making positions (i.e., the Section 16 definitions of officer). Note that, because this is an exclusive test, companies that fail to meet the definitional requirements will not be granted exceptions by the Exchange.

Despite the adoption of this formal definition of “broadly-based”, shareholder concerns persist with regard to the potential unlimited dilution that could result from a non-shareholder approved plan, potential conflicts of interest arising from officer and director participation, and the absence of proxy disclosure. In response to the dilution concerns, the NYSE has established an anti-dilution task force to assess whether an aggregate dilution limit should be applied to non-shareholder approved plans. We do not expect the definition’s adoption to precipitate major changes in plan design or cause a proliferation of non-shareholder approved plans. Rather, we expect that, consistent with their existing corporate governance policies, many companies will continue to request shareholder approval for their plans.

### **SEC Position on Shareholder Repricing Proposals<sup>3</sup>**

The SEC has contradicted a long-held position of ceding sole authority to reprice stock options to corporate boards of directors by permitting a vote on a shareholder proposal that would mandate shareholder approval of repricings. Historically, the SEC regarded such issues as “ordinary business practices,” which fall under the fiduciary responsibility of the board. The Commission relaxed this position as a result of prior deliberations involving change-in-control provisions. The policy change effectively requires one company to include these proposals as a proxy item at its annual meeting, but the ruling has implications for many companies for whom repricing may be an issue.<sup>4</sup> The change also implies increased interest on the part of institutional investors, particularly those of a company that has repriced in the past, or if the company’s existing plans permit repricing. For companies in industries where repricing may be necessary to retain key employees, such proposals may be avoided by including plan provisions to cap any aggregate repricings as a percentage of plan shares or by excluding executive officers from repricings. It will interesting to observe whether this SEC policy change helps foster an environment where proposals to change corporate by-laws further restrict the ability of a board of directors to structure its compensation programs in line with the company’s strategic goals.

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Please refer to the alert letters referenced in the footnotes and on the following summary for more detail on these topics. General information can be obtained by contacting Mark Merrigan 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](http://www.fwcook.com).

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<sup>3</sup> Alert Letter: *SEC Staff Permits Vote on Shareholder Proposal Requiring Approval of Stock Option Repricing*, February 8, 1999

<sup>4</sup> General DataComm Industries, Inc. December 9, 1998.

## 1999 “Alert” Letters

Sorted by Date

<b>SEC Staff Permits Vote on Shareholder Proposal Requiring Approval of Stock Option Repricing</b> 2/8/99	<b>SEC Approves Revised New York Stock Exchange Definition of Broadly-Based Plan</b> 6/14/99
<b>FASB Proposes to Tighten the Rules on Stock-for-Tax Withholding</b> 3/10/99	<b>FASB Begins Redeliberations on Proposed Interpretation of Opinion 25</b> 8/20/99
<b>EITF Requires Compensation Cost for Excess Stock-for-Tax Withholding Transactions</b> 4/5/99	<b>FASB Redeliberations Continue on Proposed Interpretation of Opinion 25</b> 11/18/99
<b>FASB Releases Exposure Draft on Proposed Interpretation of Opinion 25</b> 4/27/99	<b>FASB Concludes Redeliberations on Proposed Interpretation of Opinion 25</b> 1/24/00