

March 1, 1996

SUMMARY OF 1995 LEGISLATIVE AND RELATED DEVELOPMENTS AFFECTING EXECUTIVE COMPENSATION

Nineteen-ninety five was a year of closure for two significant regulatory issues. Final specifications were issued in October by the Financial Accounting Standards Board (FASB) which concluded its long-running stock compensation project. And in December, the Internal Revenue Service (IRS) issued final regulations regarding Internal Revenue Code (IRC) Section 162(m) - "the \$1 million cap". The Securities and Exchange Commission (SEC) proposed streamlined Section 16(b)-3 regulations, along with proposed changes to both executive and outside directors' pay disclosure. The National Association of Corporate Directors (NACD) published results of their Blue Ribbon Commission on Directors Compensation.

FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)

The decade-old stock accounting project was put to rest with the issuance of final standards on October 23rd by the FASB.¹ All parties were relieved to conclude the project following a lengthy and often acrimonious public debate. While the FASB was apparently not pleased with the compromise outcome, they do not intend to revisit the issue and consider it closed. The new standard was issued as Financial Accounting Standard No. 123, "Accounting for Stock-Based Compensation" (FAS 123).

Footnote Disclosure

FAS 123 encourages companies to recognize a compensation cost for virtually all employee stock-based awards including stock options, but allows companies to remain under the generally more favorable Accounting Principles Board Opinion No. 25 (APB 25). In practice, this retains the exemption of most stock option grants from expense recognition in the actual financial statements. The election to recognize grants under FAS 123 rather than APB 25 is irrevocable for all future grants regardless of grant type. Any company electing to remain under APB 25 must disclose in footnotes to its annual report the pro forma impact of stock-based grants on net income and earnings per share using the expense recognition methods required by FAS 123. This disclosure is effective for fiscal years ending after December 15, 1995 and must include awards made for fiscal

¹ See our letter of November 8, 1995

years ending after December 15, 1994. Therefore, calendar-year companies remaining under APB 25 must first comply in the 1996 annual reports (issued in 1997), and must include all awards granted in 1995 and 1996. Companies are also required to disclose the chosen recognition method in the “summary of significant accounting policies” footnote to the financial statements.

Value Determination

The calculation and recognition of cost under FAS 123 is equal to a stock-based award’s “fair value” at grant, amortized over the vesting period. Fair value for stock options granted by public companies is calculated using an option-pricing model that takes into account the six variables included in the Black-Scholes and binomial models. Fair value for stock options granted by nonpublic companies is determined using the “minimum value” model which excludes stock-price volatility as a factor. Nontransferability “discounts” or “haircuts” from the calculated fair value of the model are not permitted. However, the number of shares included may be adjusted to reflect expected forfeitures, subject to final adjustment to reflect actual forfeitures.

INTERNAL REVENUE SERVICE (IRS)

\$1 Million Cap on Compensation Deductibility

In December, the IRS issued final regulations on the disallowance of deductions for employee remuneration in excess of \$1 million which retained the major provisions contained in the 1994 proposed regulations.² The primary provisions of IRC section 162(m) are:

- Effective for tax years beginning on or after 1/1/94
- Applies only to publicly traded companies
- Covers payments made to the top five executives named in the proxy statement who are employed at year end
- Limits company tax deductibility of individual compensation to \$1 million a year, with exemptions for
 - amounts payable under formal contracts in existence on 2/17/93 and not materially modified thereafter
 - compensation qualifying as “performance-based,” and administered by an “independent” committee
 - payments made to or from tax-qualified retirement plans
 - payments after an individual is no longer named in the proxy statement (e.g., deferrals to retirement)
- Affects only company tax deductions, not individual taxation

² See our letters of June 13, 1994 and January 7, 1994

Companies who have not yet sought shareholder approval to allow exemption of stock option grants have until the first meeting of shareholders at which directors are elected that occurs after 12/31/96 to do so.

SECURITIES AND EXCHANGE COMMISSION (SEC)

Proposed Rule 16b-3 Simplification

In a shift from the current rules, the SEC has proposed a pared-down Rule 16b-3 that would greatly simplify compliance and result in exemptions for almost any imaginable stock-based compensation transaction between a company and its employees.³ The rationale behind the proposal is that stock-based compensatory transactions between a company and its officers are significantly different from open market transactions for purposes of controlling short-swing profits. The SEC notes that the potential profits are at the company's expense rather than the expense of uninformed shareholders. Also, most states have incorporation laws with strong deterrents to self-dealing. The simplification of regulations would facilitate using stock-based awards to tie officer and director compensation more closely to shareholder interests.

The SEC has proposed five different avenues of exemptive relief, meaning the transaction cannot be matched with another transaction in company stock for short-swing profit recovery purposes. The *acquisition* of a derivative security or stock would be exempt if one (and only one) of the following conditions were met:

- Granted by the Company's board of directors (without restrictions on the board's make-up)
- Awarded by a board committee comprised exclusively of two or more "non-employee" directors
- Approved by shareholders no later than the next annual shareholders meeting following the grant
- Held by the officer or director for at least six months from the grant date
- Satisfies the performance-based exemptive provisions for IRC Section 162(m)

The proposed simplified rule also would exempt any *disposition* of shares (whether acquired under a company plan or not) provided the buyer or payer is the company and the transaction is approved *in advance* by:

- The board of directors; or
- A committee of two or more "non-employee" directors; or
- Shareholders of the company.

³ See our letter of November 3, 1995

Proposed Proxy Disclosure

Just as companies are getting the hang of disclosing executive compensation in the proxy statement, the SEC has asked for comment on moving significant portions of the disclosure now required in the proxy to the Form 10-K.⁴ The SEC proposal would permit the following items to be disclosed in the company’s Form 10-K filing:

- Option/SAR Exercise and Outstanding Grants Table
- Long-term Incentive Award Table
- Pension Table or Other Defined Benefit Plan Disclosure
- Employment Contracts and Severance Arrangements
- Stock Option Repricing Table and Report

The other executive compensation disclosure elements, such as the summary compensation table and compensation committee report, would still be required in the proxy statement. Also, all disclosure elements would be required in the proxy if the company was seeking shareholder approval of any compensation plan or plan amendment.

The Form 10-K is not required to be sent to shareholders unless specifically requested in writing by a shareholder. The SEC feels that this change would streamline the proxy statement by placing “the more detailed compensation” information in the Form 10-K filing.

Directors’ Compensation Disclosure

In June the SEC proposed changes to the rules for disclosing director compensation in company proxy statements⁵. Under current requirements, compensation for non-employee directors can be disclosed textually by merely describing the standard program for all directors. As proposed, the SEC would require tabular reporting by individual using the following reader-friendly format:

DIRECTOR COMPENSATION FOR THE LAST FISCAL YEAR

Name (a)	Cash Compensation			Security Grants	
	Annual Retainer Fees(\$) (b)	Meeting Fees (\$) (c)	Consulting Fees/Other Fees (\$) (d)	Number of Shares (#) (e)	Number of Securities Underlying Option/SARs (#) (f)
Director A					
Director B					
Director C					
Etc.					

⁴ See our letter of July 21, 1995

⁵ See our letter of July 21, 1995

Any compensation elements not conducive to tabular display (e.g. retirement benefits, insurance coverage, and charitable program benefits) would be described in the narrative along with the benefit amount for each director.

BOARD OF DIRECTORS' COMPENSATION

While public scrutiny of top executive pay may have peaked in the early 1990s, the spotlight has now turned to compensation for outside directors. Coincident with increased activism by shareholders on this issue, the National Association of Corporate Directors (NACD) published the results of its Blue Ribbon Commission Study on Director Compensation.⁶ The report defines a set of five principles on which director compensation programs should be based and then presents suggestions on six “Best Practices” for companies to follow to align their programs with the principles.

Principles

1. Director compensation should be determined by the board and disclosed completely to shareholders⁷
2. Director compensation should be aligned with the long-term interests of shareholders
3. Compensation should be used to motivate director behavior
4. Directors should be adequately compensated for their time and effort
5. Director compensation should be approached on an overall basis, rather than as an array of separate elements

Best Practices

1. Establish a process by which directors can determine the compensation program in a deliberative and objective way
2. Set a substantial target for stock ownership by each director and a time period during which this target is to be met
3. Define the desirable total value of all forms of director compensation
4. Pay directors solely in the form of equity and cash -- with equity representing a substantial portion of the total up to 100 percent; dismantle existing benefit programs and avoid creating new ones⁸
5. Adopt a policy stating that a company should not hire a director or a director's firm to provide professional or financial services to the corporation
6. Disclose fully in the proxy statement the philosophy and process used in determining director compensation and the value of all elements of compensation

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⁶ See our letter of July 12, 1995

⁷ See our letter of July 21, 1995

⁸ See our letter of December 22, 1995

This letter is intended as a summary of key events and developments affecting executive compensation during 1995. Please refer to the cited alert letters for more detailed discussion of these points. Additional information may be obtained by contacting Raymond Fife in Los Angeles or any member of our firm in New York at (212) 986-6330; in Chicago at (312) 332-0910; or in Los Angeles at (310) 277-5070. Specific questions regarding a company situation should be addressed to legal counsel or accounting staff.

A chronological index of alert letters sent in 1995 as well as a subject index for all alert letters since January 1990 is attached for your reference. A copy of any of these letters may be requested directly from our offices. Any comments or questions are welcome by phone or E-mail at **fwc@pipeline.com**.

1995 Frederic W. Cook & Co. Alert Letter Index

January 18, 1995	FASB Reconsiders Methodology for Valuing Employee Stock Options and Other Equity Grants
February 13, 1995	Summary of 1994 Legislative and Related Developments Affecting Executive Compensation
March 9, 1995	FASB Tentatively Sets Effective Date and Disclosure Requirements for Stock Options Under New Accounting Standard
May 26, 1995	FASB Releases Draft of Final Standard on Accounting for Stock-Based Compensation
July 12, 1995	How Should Corporate Directors be Paid? -- NACD Presents its Views
July 21, 1995	SEC Proposes Narrowing Proxy Statement Disclosure of Executive Compensation & Expanding Director Compensation Disclosure
August 2, 1995	FASB Concludes Public Deliberation on Stock Option Accounting Project, Final Standard Expected To be Released in September
November 3, 1995	SEC Re-Proposes Rule 16b-3 Changes Which Would Vastly Simplify Compliance
November 8, 1995	FASB Releases Final Standard on Accounting for Stock-Based Compensation
December 22, 1995	Terminating Non-Employee Directors' Retirement Plans
December 26, 1995	Regulatory Implications of Deferred Stock Plans for Directors

1990 - 1995 Alert Letter Index 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
7/12/95 How Should Corporate Directors be Paid? -- NACD Presents its Views

Executive Compensation - Other

10/4/94 Let Companies Fund Executive Pensions
12/22/93 Proposed Rules on Compensation Standards at Banks and Thrifts
6/1/93 Federal Reserve Adopts Notice of Proposed Rulemaking on Compensation Standards at Insured Depository Institutions
3/4/93 NACD Blue Ribbon Commission Released its Report on Executive Compensation Issues
1/20/93 Total Shareholder Return as a Measure of Long-Term Performance
10/27/92 Auditing Executive Compensation for the Board's Compensation Committee
3/5/92 Federal Banking Agencies to Set Compensation Standards for Executives and Others at Insured Depository Institutions
1/20/92 "What's Right with Executive Compensation"
10/22/91 Federal Deposit Insurance Corporation - Proposed Rule to Limit Post-Termination Payments and Indemnification Payments
1/9/91 An Update on Reload Stock Options
12/3/90 General Mills 1990 Salary Replacement Stock Option Plan

FASB - Stock Compensation

11/8/95 FASB Releases Final Standard on Accounting for Stock-Based Compensation
8/2/95 FASB Concludes Public Deliberation on Stock Option Accounting Project; Final Standard Expected to be Released in September
5/27/95 FASB Releases Draft of Final Standard on Accounting for Stock-Based Compensation
3/9/95 FASB Tentatively Sets Effective Date and Disclosure Requirements for Stock Options Under New Accounting Standard
1/18/95 FASB Reconsiders Methodology for Valuing Employee Stock Options and Other Equity Grants
12/28/94 FASB to Allow Companies Choice on Accounting for Employee Stock Options
12/5/94 FASB Meet with Stock Option Task Force on December 2
11/18/94 FASB Describes Four Alternatives for Determining Compensation Expense for Employee Stock Options
10/17/94 Current Developments in Accounting for Stock-Based Compensation
8/15/94 FASB Considers Changing Calculation of "Cost" for Employee Stock Options to Vesting Date
6/10/94 FASB Reaffirms Stock Option Project but Delays Disclosure Requirement to Grants Made Starting in 1995
4/5/94 FASB Completes Public Hearings on Stock Option Accounting and Releases Results of Field Test
8/20/93 FASB Releases "Exposure Draft" on New Accounting Standard for Stock Options and Other Stock-Based Compensation Grants
4/12/93 FASB Commits to an Expense for Stock Option Grants Starting in 1997
3/14/93 FASB Makes Tentative Decisions on Stock Option Modification, Reloads and Tax Accounting
3/13/93 Consulting Firms Propose Changes in Stock Option Accounting to FASB
3/12/93 Summary of FASB Task Force Meeting on Accounting for Stock Compensation
2/11/93 FASB Staff Releases Partial Draft of New Accounting Standard to Task Force
12/29/92 FASB Prepares to Review Tentative Decisions on Stock Compensation Project With Task Force
10/21/92 Should the FASB Impose Compensation Expense on Broad-Based Employee Stock Option/Purchase Grants?
10/15/92 FASB Will Likely Impose Compensation Expense for Employee Stock Options Using Option-Pricing Models
9/23/92 FASB Tentatively Agrees to Remove Accounting Penalty for Performance-Based Stock Plans
9/4/92 Summary of FASB Stock Compensation Task Force Meeting (**only distributed upon request**)
8/28/92 FASB Stock Compensation Task Force Meets - Directions Mixed
6/3/92 Update of FASB Stock Compensation Project
4/15/92 FASB Holds Educational Meeting on Valuing Stock Options
1/30/92 Pressure Mounts for Valuation, Disclosure and Expensing of Stock Options at Grant
12/4/90 EITF Affirms Fixed-Plan Accounting for Stock Option Adjustments in Corporate Restructurings - With Conditions
4/23/90 FASB'S EITF Reaches Consensus on Fixed-Plan Accounting for "Reload" Options

FASB - Other

7/27/94 FASB Considers Change in Calculation of EPS
10/29/90 "Limiting Stock Appreciation Right Expense"

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4/6/93 Survey on Institutional Investor Voting Guidelines
4/14/92 Institutional Shareholder Services Introduces Black-Scholes Valuation into Their Dilution Calculations
2/24/92 Update on Institutional Shareholders - New Dilution Calculation and Survey Results
3/4/91 Institutional Shareholder Voting Guidelines Revisited

SEC - Disclosure

7/21/95 SEC Proposes Narrowing Proxy Statement Disclosure of Executive Compensation & Expanding Director Compensation Disclosure
12/9/93 SEC Adopts Changes to Executive Compensation Disclosure Rules
4/2/93 The New Rules for Executive Compensation Disclosure - A Practical Analysis
12/7/92 The New Rules for Executive Compensation Disclosure - A Practical Analysis (**revised 4/2/93**)
11/4/92 SEC Adopts Major Changes in Rules for Executive Compensation Disclosure (**revised 12/7/92**)
7/9/92 SEC Proposes Significant Changes in Executive Compensation Disclosure

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7/10/92 SEC Extends New Rule 16b-3 Transition Period One Year
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3/23/91 SEC May Have Created Obstacles for "Reload" Stock Options
3/22/91 SEC Section 16 Rule Revisions Reveal More Significant Changes Than Anticipated
1/16/91 SEC Finally Adopts Section 16 Rule Changes

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1/10/94 SEC Eliminates Preliminary Proxy Statement Filing for any Employee Plan Voting Matter
10/22/93 SEC Developments Affecting Executive Compensation
2/1/90 SEC Staff Permits Vote on Shareholder Proposal for Canceling Golden Parachutes

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6/13/94 \$1 Million Compensation Deduction Limitation Update
6/1/94 1994 Proxy Disclosure of IRC Section 162(m) Policy, Incentive Plan Approval and Option Valuation
1/7/94 \$1 Million Compensation Deduction Limitation: IRS Issues Proposed Regulations
10/21/93 \$1 Million Compensation Deduction Limitation: Details, Issues and Implications
6/3/93 \$1 Million Compensation Deduction Limitation: A Closer Look
10/8/91 Bill to Curb Executive Compensation Deductions

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11/10/93 Taxes Are Up - So is the Interest in Tax Qualified Stock Options
10/20/93 Executive Compensation Implications of the Miscellaneous Provisions of the Omnibus Budget Reconciliation Act of 1993
7/13/93 Legislation for "Performance Stock Options" Introduced into Congress
9/18/92 New Requirements for Obtaining Advance IRS Rulings for Unfunded Deferrals and Related Trusts
6/14/91 Bill Introduced to Curb Executive Pay and Broaden Shareholder Rights
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Year in Review

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