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Summary of 2000 Regulatory and Other Developments Affecting Executive Compensation

STOCK PLAN ACCOUNTING ISSUES

Year 2000 could easily be coined the year of "interpretations." Just when we thought the Financial Accounting Standards Board (FASB) concluded its 3½-year project on providing guidance on how to interpret Opinion 25 with the release of "Interpretation 44" on March 31, 2000, the Emerging Issues Task Force (EITF) was back in two months to "interpret" Interpretation 44. The result is a trail of over 30 practice issues and questions, some of which have been addressed and others that are awaiting yet another meeting. As a review, we will highlight Interpretation 44, as well as discuss the most significant developments (our personal "Top Ten List") that the EITF has interpreted this year.

SUMMARY OF INTERPRETATION 44

Interpretation 44 is intended by the FASB to provide additional clarification and guidance, within the existing framework of Opinion 25, in several areas of accounting for stock compensation that have emerged in practice over the past years. The Interpretation is effective as of July 1, 2000 and applies to grants of new stock awards and changes that occur on or after that date (*Exceptions*: stock option repricings and grants to nonemployees that occur after December 15, 1998 and stock options modified to add a reload feature after January 12, 2000).

"Top Ten List"

While the FASB, EITF, and the SEC issued many rulings dealing with stock compensation, many of these rulings affect few executive compensation professionals because of the limited applicability of the situations in which they apply. Here is our list (through March 31) of the ten rulings that have the most far-reaching impact on stock option practices.

(1) Direct and Indirect Repricing: EITF guidance provides that variable award accounting is required for otherwise fixed stock options that are modified to *directly* or *indirectly* reduce the exercise price of the award. For example, granting new stock options with an exercise period that expires upon the earlier of (1) 10 years, or (2) 30 days after the date at which the company's stock price reaches the exercise price of previously granted "underwater" stock options. In addition, the EITF clarified that variable award accounting would not apply to time-based restricted stock issued in exchange for canceling an option.

(2) Retroactive Reload Feature: EITF guidance provides that adding a reload feature to an already outstanding grant results in variable accounting, not only for the existing grant but also for the reload.

(3) Modifying Terms/Conditions of Outstanding Award: EITF guidance provides that changing the terms and conditions of an outstanding grant results in either a new measurement date or variable accounting. A new measurement date occurs if further changes to the exercise price/number of shares will not occur in future, and variable award accounting applies if there is not a practical way to ascertain whether further changes to the exercise price/number of shares will occur in the future.

(4) Exchange of Parent Options for Subsidiary Options (and Vice Versa): EITF guidance provides that exchange of parent options for subsidiary options in a "reciprocal" transaction (e.g., as part of an initial public offering of the subsidiary's stock) results in a new measurement date but not variable award accounting. Two conditions must be met: (1) no increase in aggregate "intrinsic value" (or decrease in aggregate intrinsic loss), and (2) no reduction in the ratio of exercise price per share to market price per share.

(5) Change in Status: EITF guidance provides that a new measurement date must be derived if employees retire and continue to vest in their stock options while providing services to the company. There is no impact if there are no continued services and continued vesting was part of the original terms.

(6) Stock-for-Tax Withholding: EITF guidance provides that variable award accounting applies if more than the minimum required statutory withholding is allowed in a stock-for-tax withholding transaction at volition of employee or consistently by grantor company.

(7) Privately-Held Company Grants: EITF guidance provides that privately-held companies must grant stock options at the fair value of the stock to avoid a P&L charge and ensure that shares issued upon stock option exercises are not repurchased within six months of exercise if the company wants to avoid P&L charges for the options.

(8) Non-Employee Directors Really Employees: EITF guidance provides that non-employee directors are considered employees for purposes of stock option accounting under Opinion 25.

(9) Consolidated Subsidiaries: EITF guidance provides that parent company stock grants to employees of consolidated subsidiaries qualify for favorable option accounting under Opinion 25. However, parent company grants to employees of non-consolidated subsidiaries result in accounting under FAS 123.

(10) Stock Option Rescission: EITF guidance provides that rescinding a stock option exercise and reinstating the original option will result in variable accounting for the reinstated option.

SEC ISSUES

NONSHAREHOLDER APPROVED STOCK OPTION PLANS

As a result of the SEC's approval of the New York Stock Exchange's (NYSE) "broadly-based" definition on June 4, 1999, shareholder concern persisted around potentially unlimited dilution that could result from nonshareholder approved employee equity plans. In response, the SEC requested that the NYSE work with the Nasdaq to develop

acceptable shareholder approval requirements for broadly-based plans during a pilot period that was to last until September 30, 2000 (now under extension).
The NYSE has developed and submitted for review to Nasdaq a proposal that would potentially replace the existing exemptions for broadly-based plans with more rigorous standards. The main points of the NYSE proposal include the following:

(1) Requiring shareholder approval of all stock option plans in which officers and directors participate

(2) Capping the number of shares in nonshareholder approved plans and arrangements (including broadly-based plans, new hire grants, and merger awards) at 10% of aggregate shares currently available in all shareholder-approved programs maintained by the company

(3) Requiring grants funded through treasury shares to be subject to shareholder approval requirements, i.e., elimination of the "treasury stock" exemption (which currently exists only at the NYSE)

But before responding to the SEC, the Nasdaq has requested public comment on the proposal and is now developing its response.

In addition, the SEC is proposing revisions to proxy disclosure requirements contained in Regulation S-K. Currently, companies do not have to disclose the total number of securities they have authorized for their equity compensation programs on an ongoing basis (unless "material" in which case disclosure is necessary under GAAP), unless new plans are proposed or modified.

In response, the SEC is proposing equity compensation plan information to be disclosed in an amended table format to include:

(1) Number of securities authorized for issuance under each plan, whether shareholder approved or not

(2) Number of securities awarded plus the number of securities to be issued upon exercise of options, warrants or rights granted during the last fiscal year

(3) Number of securities to be issued upon exercise of outstanding options, warrants or rights

(4) Number of securities remaining available for future issuance

These changes would result in shareholders and analysts receiving more detailed information on stock option and other equity plans in which dilution calculations could be conducted easily.

NEW INSIDER TRADING RULE

Effective October 23, 2000, the SEC has adopted Rule 10b5-1 to help clarify issues related to insider trading. This new ruling allows insiders and other investors (such as top executives and board members) to buy or sell stock in their companies regardless of the inside information they have as long as they have committed in advance with no insider information at the time of the commitment.

The SEC provides three instances in which executives can buy or sell securities and not violate insider trading laws:

(1) Executive enters into a binding contract to purchase or sell the security prior to their becoming aware of inside information

(2) Executive demonstrates that the trade was executed in advance of becoming aware of the information

(3) Executive demonstrates that a written plan for trading securities was adopted prior to becoming aware of the information

The new insider trading rule remains consistent with Section 10(b) of the Securities Exchange Act of 1934 in which it is unlawful for any person to employ any deceptive or manipulative device in connection with the purchase or sale of a security. The rules allow executives to be free from prosecution if it can be demonstrated that material nonpublic information was not a factor in making a trading decision. The new policy will allow large shareowners (e.g., founders) to use a formulaic policy to sell shares over a period of time. This could potentially help companies avoid large "sell-offs" that adversely affect stock price, which can occur when a large shareowner retires.

OTHER LEGISLATIVE ISSUES

WORKER ECONOMIC OPPORTUNITY ACT

The Senate passed a bill titled "Worker Economic Opportunity Act" that would exempt stock option gains from overtime calculations proposed by the Fair Labor Standards Act (FLSA) on broadly-based grants if the terms and conditions of the program included:

(1) Communication to employees when they were hired or when they received the grant

(2) Options and SAR would have a minimum six month vesting period and a purchase price of at least 85% of the stock's fair market value on the date of the grant

(3) Participation is voluntary

(4) Awards cannot be dependent on future performance of any individual

The legislation is a win for the business community as companies will be able to continue granting stock options throughout broadly-based employee groups without including stock option gains in the base rate to calculate overtime pay for their employees.

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Please refer to the alert letter reference in the footnotes for more detail on these topics. General information can be obtained by contacting Malia Mixon in our Chicago office at (312) 332-0910 or any other member of the firm. This letter and other published materials are available on our Web site, www.fwcook.com.

"Alert" Letters Referenced

Sorted by Date

Congressional Hearing on Including Stock Option Gain in Base Rate for Overtime Pay May Lead to New Legislation **3/14/00**	House Ways and Means Subcommittee Holds Hearing on Employee Stock Option Plans **10/19/00**
Another Perspective On The Cost of Stock Options **4/19/00**	Nasdaq Stock Market Requests Public Comments on Shareholder Approval Issue **12/14/00**
Senate Passed Bill That Would Exempt Stock Option Gains From Overtime Calculations **4/19/00**	An Advisory to Compensation Professionals on the Use of Compensation Survey 2001 **12/15/00**
FASB Interpretation No. 44 – Accounting for Certain Transactions Involving Stock Compensation **5/1/00**	Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44 **1/9/01**
Summary of FASB Interpretation No. 44 **5/10/00**	EITF Continues to Issue New Guidance on Accounting for Stock Compensation **1/9/01**
Bill for New Form of Tax-Favored Employee Stock Purchase Plans Introduced **8/2/00**	SEC Issues Accounting Guidance for Stock Option Exercise Rescissions **2/16/01**
FASB and EITF Issue Rulings on Accounting for Stock Compensation **9/15/00**	Proposed SEC Disclosure Rules for Equity Compensation Plans **2/23/01**
EITF Resolves Several Stock Option Accounting Issues **10/11/00**	Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44 **3/7/01**
New Insider Trading Rule to Provide Clarity for Insiders **10/18/00**	EITF Continues its Deliberations on Issue No. 00-23 **3/7/01**