WISCONSIN ENERGY CORP
Form DEF 14A
April 02, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Amendment No.)

Filed by the Registrant x

Filed by a Party other than the Registrant ¨

Check the appropriate box:

¨ Preliminary Proxy Statement

¨ **Confidential, for use of the Commission Only (as permitted by Rule 14a-6(e)(2))**

x Definitive Proxy Statement

¨ Definitive Additional Materials

¨ Soliciting Material Pursuant to (S) 240.14a-11(c) or (S) 240.14a-12

Wisconsin Energy Corporation

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x No fee required.

¨ Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

(5) Total fee paid:

¨ Fee paid previously with preliminary materials.

¨ Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

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NOTICE OF ANNUAL MEETING OF STOCKHOLDERS

April 2, 2009

To the Stockholders of Wisconsin Energy Corporation:

You are cordially invited to attend the 2009 Annual Meeting of Stockholders. **An admission ticket will be required to enter the meeting**. Your admission ticket, which also includes a map to the meeting, is located on your proxy card. Instructions on how to obtain an admission ticket if you received your proxy materials electronically are provided on page P-6 of the proxy statement. If you are not able to attend the Annual Meeting, you may listen to a live webcast available on the Wisconsin Energy Web site at: www.wisconsinenergy.com/invest/annualmtg.htm. An archive of the webcast will be available on this Web site for approximately 12 months following the meeting. **Regardless of whether you plan to attend, please take a moment to vote your proxy**. The meeting will be held as follows:

WHEN:	Thursday, May 7, 2009 10:00 a.m., Central time
WHERE:	Cedarburg Performing Arts Center W68 N611 Evergreen Boulevard Cedarburg, Wisconsin 53012
ITEMS OF BUSINESS:	Election of nine directors for terms expiring in 2010. Ratification of Deloitte & Touche LLP as independent auditors for 2009. Consideration of any other matters that may properly come before the meeting.
RECORD DATE:	February 26, 2009
VOTING BY PROXY:	*Your vote is important*. You may vote: using the Internet; by telephone; or by returning the proxy card in the envelope provided.

Important Notice Regarding the Availability of Proxy Materials for the Stockholder Meeting to Be Held on May 7, 2009 The Proxy Statement and 2008 Annual Report are available at:

http://bnymellon.mobular.net/bnymellon/wec

By Order of the Board of Directors,

Susan H. Martin
Vice President, Corporate Secretary and Associate General Counsel

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PROXY STATEMENT

This proxy statement is being furnished to stockholders beginning on or about April 2, 2009, in connection with the solicitation of proxies by the Wisconsin Energy Corporation (WEC or the Company) Board of Directors (the Board) to be used at the Annual Meeting of Stockholders on Thursday, May 7, 2009 (the Meeting) at 10:00 a.m., Central time, at the Cedarburg Performing Arts Center located at W68 N611 Evergreen Boulevard, Cedarburg, Wisconsin 53012, and at all adjournments or postponements of the Meeting, for the purposes listed in the preceding Notice of Annual Meeting of Stockholders.

GENERAL INFORMATION FREQUENTLY ASKED QUESTIONS

What am I voting on?	**Proposal 1:** Election of nine directors for terms expiring in 2010.
	Proposal 2: Ratification of Deloitte & Touche LLP as independent auditors for 2009.
	The Company is not aware of any other matters that will be voted on. If a matter does properly come before the Meeting, the persons named as the proxies in the accompanying form of proxy will vote the proxy at their discretion.
What are the Board s voting recommendations?	The Board of Directors recommends a vote:
	FOR each of the nine nominated directors, and
	FOR ratification of Deloitte & Touche LLP as independent auditors for 2009.
What is the vote required for each proposal?	**Proposal 1:** The nine individuals receiving the largest number of votes will be elected as directors.
	Proposal 2: Ratification of the independent auditors requires the affirmative vote of a majority of the votes cast in person or by proxy at the Meeting.
Who can vote?	Common stockholders as of the close of business on the record date, February 26, 2009, can vote. Each outstanding share of WEC common stock is entitled to one vote upon each matter presented. A list of stockholders entitled to vote will be available for inspection by stockholders at WEC s principal business office, 231 West Michigan Street, Milwaukee, Wisconsin 53203, prior to the Meeting. The list also will be available at the Meeting.
How do I vote?	There are several ways to vote:
	By Internet. The Company encourages you to vote this way.

By toll-free touch-tone telephone.

By completing and mailing the enclosed proxy card.

By written ballot at the Meeting.

Instructions to vote through the Internet or by telephone are listed on your proxy card or the information forwarded to you by your bank or broker. The Internet and telephone voting facilities will close at 10:59 p.m., Central time, on Wednesday, May 6, 2009.

If you are a participant in WEC s Stock Plus Investment Plan (Stock Plus) or own shares through investments in the WEC Common Stock Fund or WEC Common Stock ESOP Fund in WEC s 401(k) plan, your proxy will serve as voting instructions for your shares held in those plans. The administrator for Stock Plus and the trustee for the 401(k) plan will vote your shares as you direct. If a proxy is not returned for shares held in Stock Plus, the administrator will not vote those shares. If a proxy is not returned for shares held in the 401(k) plan, the trustee will vote those shares in the same proportion that all shares in the WEC Common Stock Fund or WEC Common Stock ESOP Fund, as the case may be, for which voting instructions have been received, are voted.

If you are a beneficial owner and your broker holds your shares in its name, the broker is permitted to vote your shares in the election of directors and ratification of the independent auditors even if the broker does not receive voting instructions from you. If your shares are held in the name of a broker, bank or other holder of record, you are invited to attend the Meeting, but may not vote at the Meeting unless you have first obtained a proxy executed in your favor from the holder of record.

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What does it mean if I get more than one proxy?	It means your shares are held in more than one account. Please vote all proxies to ensure all of your shares are counted.
What constitutes a quorum?	As of the record date, there were 116,914,008 shares of WEC common stock outstanding. In order to conduct the Meeting, a majority of the outstanding shares entitled to vote must be represented in person or by proxy. This is known as a quorum. Abstentions and shares which are the subject of broker non-votes will count toward establishing a quorum.
Can I change my vote?	You may change your vote or revoke your proxy at any time prior to the closing of the polls, by: entering a new vote by Internet or phone; returning a later-dated proxy card; voting in person at the Meeting; or notifying WEC s Corporate Secretary by written revocation letter. The Corporate Secretary is Susan H. Martin. Any revocation should be filed with her at WEC s principal business office, 231 West Michigan Street, P. O. Box 1331, Milwaukee, Wisconsin 53201. Attendance at the Meeting will not, in itself, constitute revocation of a proxy. All shares entitled to vote and represented by properly completed proxies timely received and not revoked will be voted as you direct. If no direction is given in a properly completed proxy, the proxy will be voted as the Board recommends.
Who conducts the proxy solicitation?	The WEC Board is soliciting these proxies. WEC will bear the cost of the solicitation of proxies. WEC contemplates that proxies will be solicited principally through the use of the mail, but employees of WEC or its subsidiaries may solicit proxies by telephone, personally or by other communications, without compensation apart from their normal salaries. It is not anticipated that any other persons will be engaged to solicit proxies or that compensation will be paid for that purpose. However, WEC may seek the services of an outside proxy solicitor in the event that such services become necessary.
Who will count the votes?	BNY Mellon Shareowner Services, which also will serve as Inspector of Election, will tabulate voted proxies.
How can I attend the Meeting?	The Meeting is open to all stockholders of WEC. **You must bring an admission ticket or other evidence of your ownership to enter the Meeting.** If you received proxy materials by mail, your admission ticket is included on your proxy card. The admission ticket admits the stockholder and one guest. If your shares are jointly owned and you need an additional ticket, or if you need directions to the Meeting or have questions regarding this process, contact Stockholder Services, 231 West Michigan Street, P.O. Box 1331, Milwaukee, Wisconsin 53201 or call 800-881-5882. A map to the Meeting is included on the admission ticket.
What information is available via the Internet?	The following documents can be found at http://bnymellon.mobular.net/bnymellon/wec

- Notice of Annual Meeting;
- Proxy Statement;
- 2008 Annual Report; and
- Form of Proxy.

How do I obtain an admission ticket if I received my proxy materials electronically?	If your shares are registered in your name, you can print an admission ticket by following the instructions provided in the e-mail which transmitted your proxy materials. If you hold your shares through a bank, brokerage firm, or other nominee, call 800-881-5882 or write to Stockholder Services at the above address to request an admission ticket. We will send you an admission ticket upon verification of your ownership. You may also bring a copy of your account statement or other evidence of your ownership as of the record date to the Meeting. This document will serve as your admission ticket.

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What steps has WEC taken to reduce the cost of proxy solicitation?	WEC has implemented several practices that reduce printing and postage costs and are friendly to the environment. WEC encourages you to choose MLink℠ for fast and secure 24/7 online access to proxy materials, investment plan statements, tax documents and more. Simply log on to Investor ServiceDirect® at www.bnymellon.com/shareowner/isd where step-by-step instructions will prompt you on how to enroll in MLink℠. The Company also has:

encouraged Internet and telephone voting of your proxies; and

implemented householding whereby stockholders sharing a single address receive a single annual report and proxy statement, unless the Company received instructions to the contrary from one or more of the stockholders.

If you received multiple copies of the annual report and proxy statement, you may wish to contact the Company s transfer agent, BNY Mellon Shareowner Services, at 800-558-9663 to request householding, or you may provide written instructions to Wisconsin Energy Corporation, c/o BNY Mellon Shareowner Services, P.O. Box 358015, Pittsburgh, PA 15252-8015. If you wish to receive separate copies of the annual report and proxy statement now or in the future, or to discontinue householding entirely, you may contact the Company s transfer agent using the contact information provided above. Upon request, the Company will promptly send a separate copy of either document. Whether or not a stockholder is householding, each stockholder will continue to receive a proxy card. If your shares are held through a bank, broker or other holder of record, you may request householding by contacting the holder of record.

Who do I contact if I have questions about the Meeting or my account?	If you need more information about the Meeting, write to Stockholder Services, 231 West Michigan Street, P.O. Box 1331, Milwaukee, Wisconsin 53201, or call us at 800-881-5882. For information about shares registered in your name or your Stock Plus account, call our transfer agent, BNY Mellon Shareowner Services, at 800-558-9663, or access your account via the Internet at www.bnymellon.com/shareowner/isd.

PROPOSALS TO BE VOTED UPON

PROPOSAL 1: ELECTION OF DIRECTORS TERMS EXPIRING IN 2010

WEC s Bylaws require each director to be elected annually to hold office for a one-year term. Directors will be elected by a plurality of the votes cast by the shares entitled to vote, as long as a quorum is present. Plurality means that the individuals who receive the largest number of votes are elected as directors up to the maximum number of directors to be chosen. Therefore, presuming a quorum is present, shares not voted, whether by withheld authority or otherwise, have no effect in the election of directors.

The Board s nominees for election are:

John F. Bergstrom

Barbara L. Bowles

Patricia W. Chadwick

Robert A. Cornog

Curt S. Culver

Thomas J. Fischer

Gale E. Klappa

Ulice Payne, Jr.

Frederick P. Stratton, Jr.

Proxies may not be voted for more than nine persons in the election of directors.

Each nominee has consented to being nominated and to serve if elected. In the unlikely event that any nominee becomes unable to serve for any reason, the proxies will be voted for a substitute nominee selected by the Board upon the recommendation of the Corporate Governance Committee of the Board. Biographical information regarding each nominee is included on the next pages.

The Board of Directors recommends that you vote FOR all of the director nominees.

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Information about Nominees for Election to the Board of Directors. Wisconsin Electric Power Company (WE) and Wisconsin Gas LLC (WG) do business as We Energies and are wholly-owned subsidiaries of Wisconsin Energy Corporation. Ages and biographical information are as of March 1, 2009.

John F. Bergstrom. Age 62.

Bergstrom Corporation   Chairman since 1982 and Chief Executive Officer since 1974. Bergstrom Corporation owns and operates numerous automobile sales and leasing companies.

Director of Advance Auto Parts Inc. and Kimberly-Clark Corporation.

Director of Wisconsin Energy Corporation since 1987, Wisconsin Electric Power Company since 1985 and Wisconsin Gas LLC since 2000.

Barbara L. Bowles. Age 61.

Profit Investment Management   Retired Vice Chair. Served as Vice Chair from January 2006 until retirement in December 2007. Profit Investment Management is an investment advisory firm.

The Kenwood Group, Inc.   Retired Chairman. Served as Chairman from 2000 until June 2006 when The Kenwood Group, Inc. merged into Profit Investment Management. Chief Executive Officer from 1989 to December 2005.

Director of Black & Decker Corporation and Hospira, Inc.

Director of Wisconsin Energy Corporation and Wisconsin Electric Power Company since 1998 and Wisconsin Gas LLC since 2000.

Patricia W. Chadwick. Age 60.

Ravengate Partners, LLC   President since 1999. Ravengate Partners, LLC provides businesses and not-for-profit institutions with advice about the financial markets.

Director of AMICA Mutual Insurance Company and ING Mutual Funds.

Director of Wisconsin Energy Corporation, Wisconsin Electric Power Company and Wisconsin Gas LLC since 2006.

Robert A. Cornog. Age 68.

Snap-on Incorporated Retired Chairman of the Board, President and Chief Executive Officer. Served as President and Chief Executive Officer from 1991 until 2001 and as Chairman from 1991 until 2002. Snap-on Incorporated is a developer, manufacturer and distributor of professional hand and power tools, diagnostic and shop equipment, and tool storage products.

Director of Johnson Controls, Inc.

Director of Wisconsin Energy Corporation since 1993, Wisconsin Electric Power Company since 1994 and Wisconsin Gas LLC since 2000.

Curt S. Culver. Age 56.

MGIC Investment Corporation Chairman since 2005, Chief Executive Officer since 2000 and President from 1999 to January 2006. MGIC Investment Corporation is the parent of Mortgage Guaranty Insurance Corporation.

Mortgage Guaranty Insurance Corporation Chairman since 2005, Chief Executive Officer since 1999 and President from 1996 to January 2006. Mortgage Guaranty Insurance Corporation is a private mortgage insurance company.

Director of MGIC Investment Corporation.

Director of Wisconsin Energy Corporation, Wisconsin Electric Power Company and Wisconsin Gas LLC since 2004.

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Thomas J. Fischer. Age 61.

Fischer Financial Consulting LLC Principal since 2002. Fischer Financial Consulting LLC provides consulting on corporate financial, accounting and governance matters.

Arthur Andersen LLP Retired as Managing Partner of the Milwaukee office in 2002. Served as Managing Partner from 1993 and as Partner from 1980. Arthur Andersen LLP was an independent public accounting firm.

Director of Actuant Corporation, Badger Meter, Inc. and Regal-Beloit Corporation.

Director of Wisconsin Energy Corporation, Wisconsin Electric Power Company and Wisconsin Gas LLC since 2005.

Gale E. Klappa. Age 58.

Wisconsin Energy Corporation Chairman of the Board and Chief Executive Officer since May 2004. President since April 2003.

Wisconsin Electric Power Company Chairman of the Board since May 2004. President and Chief Executive Officer since August 2003.

Wisconsin Gas LLC Chairman of the Board since May 2004. President and Chief Executive Officer since August 2003.

Director of Joy Global Inc.

Director of Wisconsin Energy Corporation, Wisconsin Electric Power Company and Wisconsin Gas LLC since 2003.

Ulice Payne, Jr. Age 53.

Addison-Clifton, LLC Managing Member since 2004. Addison-Clifton, LLC provides advisory services on global trade compliance.

Milwaukee Brewers Baseball Club, Inc. President and Chief Executive Officer from 2002 to 2003.

Director of Badger Meter, Inc. and Manpower Inc., and Trustee of The Northwestern Mutual Life Insurance Company.

Director of Wisconsin Energy Corporation, Wisconsin Electric Power Company and Wisconsin Gas LLC since 2003.

Frederick P. Stratton, Jr. Age 69.

Briggs & Stratton Corporation Chairman Emeritus since 2003. Chairman of the Board from 2001 to 2003. Chairman and Chief Executive Officer from 1986 until 2001. Briggs & Stratton Corporation is a manufacturer of small gasoline engines.

Director of Baird Funds, Inc. and Weyco Group, Inc.

Director of Wisconsin Energy Corporation since 1987, Wisconsin Electric Power Company since 1986 and Wisconsin Gas LLC since 2000.

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PROPOSAL 2: RATIFICATION OF DELOITTE & TOUCHE LLP AS INDEPENDENT AUDITORS FOR 2009

The Audit and Oversight Committee of the Board of Directors has sole authority to select, evaluate and, where appropriate, terminate and replace the independent auditors. The Audit and Oversight Committee has appointed Deloitte & Touche LLP as the Company s independent auditors for the fiscal year ending December 31, 2009. The Committee believes that stockholder ratification of this matter is important considering the critical role the independent auditors play in maintaining the integrity of the Company s financial statements. If stockholders do not ratify the selection of Deloitte & Touche LLP, the Audit and Oversight Committee will reconsider the selection.

Deloitte & Touche LLP also served as the independent auditors for the Company for the last seven fiscal years beginning with the fiscal year ended December 31, 2002.

Representatives of Deloitte & Touche LLP are expected to be present at the Meeting. They will have an opportunity to make a statement if they so desire and are expected to respond to appropriate questions that may be directed to them.

The appointment of Deloitte & Touche LLP as independent auditors for 2009 will be ratified if the number of votes cast in favor of the proposal exceeds the number of votes cast against the proposal. Accordingly, presuming a quorum is present, abstentions and broker non-votes will have no effect on the outcome of this proposal.

The Board of Directors recommends that you vote FOR

the ratification of Deloitte & Touche LLP as independent auditors for 2009.

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INDEPENDENT AUDITORS FEES AND SERVICES

Pre-Approval Policy. The Audit and Oversight Committee has a formal policy delineating its responsibilities for reviewing and approving, in advance, all audit, audit-related, tax and other services of the independent auditors. The Committee is committed to ensuring the independence of the auditors, both in appearance as well as in fact.

Under the pre-approval policy, before engagement of the independent auditors for the next year s audit, the independent auditors will submit a description of services anticipated to be rendered for the Committee to approve. Annual pre-approval will be deemed effective for a period of twelve months from the date of pre-approval, unless the Committee specifically provides for a different period. A fee level will be established for all permissible non-audit services. Any proposed non-audit services exceeding this level will require additional approval by the Committee.

The Audit and Oversight Committee delegated pre-approval authority to the Committee s Chair. The Committee Chair shall report any pre-approval decisions at the next scheduled Committee meeting. Under the pre-approval policy, the Committee shall not delegate to management its responsibilities to pre-approve services performed by the independent auditors.

Under the pre-approval policy, prohibited non-audit services are services prohibited by the Securities and Exchange Commission or by the Public Company Accounting Oversight Board to be performed by the Company s independent auditors. These services include bookkeeping or other services related to the accounting records or financial statements of the Company, financial information systems design and implementation, appraisal or valuation services, fairness opinions or contribution-in-kind reports, actuarial services, internal audit outsourcing services, management functions or human resources, broker-dealer, investment advisor or investment banking services, legal services and expert services unrelated to the audit, services provided for a contingent fee or commission and services related to planning, marketing or opining in favor of the tax treatment of a confidential transaction or an aggressive tax position transaction that was initially recommended, directly or indirectly, by the independent auditors. In addition, the Committee has determined that the independent auditors may not provide any services, including personal financial counseling and tax services, to any officer of the Company or member of the Audit and Oversight Committee or an immediate family member of these individuals, including spouses, spousal equivalents and dependents.

Fee Table. The following table shows the fees, all of which were pre-approved by the Audit and Oversight Committee, for professional audit services provided by Deloitte & Touche LLP for the audit of the annual financial statements of the Company and its subsidiaries for fiscal years 2008 and 2007 and fees for other services rendered during those periods. No fees were paid to Deloitte & Touche LLP pursuant to the de minimus exception to the pre-approval policy permitted under the Securities Exchange Act of 1934, as amended.

	2008	**2007**
Audit Fees [1]	$ 1,703,570	$ 1,528,432
Audit-Related Fees [2]		44,400
Tax Fees [3]	700,835	634,739
All Other Fees [4]	4,171	4,325
Total	$ 2,408,576	$ 2,211,896

(1) *Audit Fees* consist of fees for professional services rendered in connection with the audits of (1) annual financial statements of the Company and its subsidiaries, and (2) the effectiveness of internal control over financial reporting. This category also includes reviews of financial statements included in Form 10-Q filings of the Company and its subsidiaries and services normally provided in connection with statutory and regulatory filings or engagements.

(2) *Audit-Related Fees* consist of fees for professional services that are reasonably related to the performance of the audit or review of the Company s financial statements and are not reported under Audit Fees. These services primarily include consultations regarding implementation of accounting standards.

(3) *Tax Fees* consist of fees for professional services rendered with respect to federal and state tax compliance and tax advice. During 2008 and 2007, this included tax strategy consulting for the utilities.

(4) *All Other Fees* consist of costs for certain employees to attend accounting/tax seminars hosted by Deloitte & Touche LLP in 2008 and 2007.

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CORPORATE GOVERNANCE FREQUENTLY ASKED QUESTIONS

Does WEC have Corporate Governance Guidelines?	Yes, since 1996 the Board has maintained Corporate Governance Guidelines that provide a framework under which it conducts business. The Corporate Governance Committee reviews the Guidelines annually to ensure that the Board is providing effective governance over the affairs of the Company. The Guidelines are available in the Governance section of the Company s website at www.wisconsinenergy.com and are available in print to any stockholder who requests them in writing from the Corporate Secretary.
How are directors determined to be independent?	No director qualifies as independent unless the Board affirmatively determines that the director has no material relationship with the Company. The Corporate Governance Guidelines provide that the Board should consist of at least a two-thirds majority of independent directors.
What are the Board s standards of independence?	The guidelines the Board uses in determining director independence are located in Appendix A of the Corporate Governance Guidelines. These standards of independence, which are summarized below, include those established by the New York Stock Exchange as well as a series of standards that are more comprehensive than New York Stock Exchange requirements. A director will be considered independent by the Board if the director:

has not been an employee of the Company for the last five years;

has not received, in the past three years, more than $120,000 per year in direct compensation from the Company, other than director fees or deferred compensation for prior service;

is not a current partner or employee of a firm that is the Company s internal or external auditor, was not within the last three years a partner or employee of such a firm and personally worked on the Company s audit within that time, or has no immediate family member who is a current employee of such a firm and personally works on the Company s audit;

has not been an executive officer, in the past three years, of another company where any of the Company s present executives at the same time serves or served on that other company s compensation committee;

in the past three years, has not been an employee of a company that makes payments to, or receives payments from, the Company for property or services in an amount which in any single fiscal year is the greater of $1 million or 2% of such other company s consolidated gross revenues;

has not received, in the past three years, remuneration, other than *de minimus* remuneration, as a result of services as, or being affiliated with an entity that serves as, an advisor, consultant, or legal counsel to the Company or to a member of the Company s senior management, or a significant supplier of the Company;

has no personal service contract(s) with the Company or any member of the Company s senior management;

is not an employee or officer with a not-for profit entity that receives 5% or more of its total annual charitable awards from the Company;

has not had any business relationship with the Company, in the past three years, for which the Company has been required to make disclosure under certain rules of the Securities and Exchange Commission;

is not employed by a public company at which an executive officer of the Company serves as a director; and

does not have any beneficial ownership interest of 5% or more in an entity that has received remuneration, other than *de minimus* remuneration, from the Company, its subsidiaries or affiliates.

The Board also considers whether a director s immediate family members meet the above criteria, as well as whether a director has any relationships with WEC s affiliates for certain of the above criteria, when determining the director s independence. Any relationship between a director and the Company not meeting the above criteria is considered an immaterial relationship with the Company for purposes of determining independence.

Who are the independent directors?

The Board has affirmatively determined that Directors Bergstrom, Bowles, Chadwick, Cornog, Culver, Fischer, Payne and Stratton have no relationships within the Board s standards of independence noted above and otherwise have no material relationships with WEC and are independent. This represents 89% of the Board. Director Klappa is not independent due to his present employment with WEC. John F. Ahearne, who did not stand for re-election at the 2008 Annual Meeting of Stockholders, was independent.

What are the committees of the Board?	The Board of Directors has the following committees: Audit and Oversight, Compensation, Corporate Governance, Finance, and Executive.
	All committees, except the Executive Committee, operate under a charter approved by the Board. A copy of each committee charter is posted in the Governance section of the Company s website at www.wisconsinenergy.com and is available in print to any stockholder who requests it in writing from the Corporate Secretary. The members and the responsibilities of each committee are listed later in this proxy statement under the heading Committees of the Board of Directors.
Are the Audit and Oversight, Corporate Governance and Compensation Committees comprised solely of independent directors?	Yes, these committees are comprised solely of independent directors, as determined under New York Stock Exchange rules and the Board s Corporate Governance Guidelines.
	In addition, the Board has determined that each member of the Audit and Oversight Committee is independent under the rules of the New York Stock Exchange applicable to audit committee members. The Audit and Oversight Committee is a separately designated committee established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934, as amended.
Do the non-management directors meet separately from management?	Yes, at every regularly scheduled Board meeting non-management (non-employee) directors meet in executive session without any management present. All non-management directors are independent. The chair of the Corporate Governance Committee, currently Director Bowles, presides at these sessions.
How can interested parties contact the members of the Board?	Correspondence may be sent to the directors, including the non-management directors, in care of the Corporate Secretary, Susan H. Martin, at the Company s principal business office, 231 West Michigan Street, P.O. Box 1331, Milwaukee, Wisconsin 53201.
	All communication received as set forth above will be opened by the Corporate Secretary for the sole purpose of confirming the contents represent a message to the Company s directors. All communication, other than advertising, promotion of a product or service, or patently offensive material, will be forwarded promptly to the addressee.
Does the Company have a written code of ethics?	Yes, all WEC directors, executive officers and employees, including the principal executive, financial and accounting officers, have a responsibility to comply with WEC s Code of Business Conduct, to seek advice in doubtful situations and to report suspected violations.
	WEC s Code of Business Conduct addresses, among other things: conflicts of interest; confidentiality; fair dealing; protection and proper use of Company assets; and compliance with laws, rules and regulations (including insider trading laws). The Company has not provided any waiver to the Code for any director, executive officer or other employee.
	The Code of Business Conduct is posted in the Governance section of the Company s website at www.wisconsinenergy.com. It is also available in print to any stockholder upon request in writing to the Corporate Secretary.

The Company has contracted with an independent call center for employees to confidentially report suspected violations of the Code of Business Conduct or other concerns regarding accounting, internal accounting controls or auditing matters.

Does the Company have policies and procedures in place to review and approve related party transactions?

All employees of WEC, including executive officers and members of the Board, are required to comply with WEC s Code of Business Conduct. The Code addresses, among other things, what actions are required when potential conflicts of interest may arise, including those from related party transactions. Specifically, executive officers and members of the Board are required to obtain approval of the Audit and Oversight Committee chair (1) before obtaining any financial interest in or participating in any business relationship with any company, individual or concern doing business with WEC or any of its subsidiaries, (2) before participating in any joint venture, partnership or other business relationship with WEC or any of its subsidiaries, and (3) before serving as an officer or member of the board of any substantial outside for-profit organization (except the Chief Executive Officer must obtain the approval of the full Board before doing so and members of the Board of Directors must obtain the prior approval of the Corporate Governance Committee). Executive officers must obtain the prior approval of the Chief Executive Officer before accepting a position with a substantial non-profit organization; members of the Board must notify the Compliance Officer when joining such a non-profit organization, but do not need to obtain

	approval prior to joining the organization.
	In addition, WEC s Code of Business Conduct requires employees to notify the Compliance Officer of situations where family members are a supplier or significant customer of WEC or employed by one. To the extent the Compliance Officer deems it appropriate, she will consult with the Audit and Oversight Committee chair in situations involving executive officers and members of the Board.
Does the Board evaluate CEO performance?	Yes, the Compensation Committee, on behalf of the Board, annually evaluates the performance of the CEO and reports the results to the Board. As part of this practice, the Compensation Committee requests that all non-employee directors provide their opinions to the Compensation Committee chair on the CEO s performance.
	The CEO is evaluated in a number of areas including leadership, vision, financial stewardship, strategy development, management development, effective communication with constituencies, demonstrated integrity and effective representation of the Company in community and industry affairs. The chair of the Compensation Committee shares the responses with the CEO. The process is also used by the Committee to determine appropriate compensation for the CEO. This procedure allows the Board to evaluate the CEO and to communicate the Board s expectations.
Does the Board evaluate its own performance?	Yes, the Board annually evaluates its own collective performance. Each director is asked to consider the performance of the Board on such things as: the establishment of appropriate corporate governance practices; providing appropriate oversight for key affairs of the Company (including its strategic plans, long-range goals, financial and operating performance and customer satisfaction initiatives); communicating the Board s expectations and concerns to the CEO; monitoring threats and overseeing opportunities critical to the Company; and operating in a manner that ensures open communication, candid and constructive dialogue as well as critical questioning. The Corporate Governance Committee uses the results of this process as part of its annual review of the Corporate Governance Guidelines and to foster continuous improvement of the Board s activities.
Is Board committee performance evaluated?	Yes, each committee, except the Executive Committee, conducts an annual performance evaluation of its own activities and reports the results to the Board. The evaluation compares the performance of each committee with the requirements of its charter. The results of the annual evaluations are used by each committee to identify both its strengths and areas where its governance practices can be improved. Each committee may adjust its charter, with Board approval, based on the evaluation results.
Are all the members of the audit committee financially literate and does the committee have an audit committee financial expert ?	Yes, the Board has determined that all of the members of the Audit and Oversight Committee are financially literate as required by New York Stock Exchange rules and qualify as audit committee financial experts within the meaning of Securities and Exchange Commission rules. Director Fischer serves on the audit committee of three other public companies. The Board determined that his service on these other audit committees will not impair Director Fischer s ability to effectively serve on the Audit and Oversight Committee. No other member of the Audit and Oversight Committee serves as an audit committee member of more than three public companies. For this purpose, the Company considers service on the audit committees of Wisconsin Energy Corporation and Wisconsin Electric Power Company to be service on the audit committee of one public company because of the commonality of the issues considered by those committees.
What are the principal processes and procedures used by the Compensation Committee to determine executive and director compensation?	One of the principal responsibilities of the Compensation Committee is to provide a competitive, performance-based executive and director compensation program. This includes: (1) determining and periodically reviewing the Committee s compensation philosophy; (2) determining and reviewing the compensation paid to executive officers (including base salaries, incentive compensation and benefits); (3) oversight of the compensation and benefits to be paid to other officers and key employees; and (4) establishing and administering the Chief Executive Officer compensation package. The Compensation

Committee is also charged with administering the compensation package of WEC s non-employee directors. Although it has not chosen to do so, the Committee may delegate all or a portion of its duties and responsibilities to a subcommittee of the Committee.

The Chief Executive Officer, after reviewing compensation data compiled by Towers Perrin, a compensation consulting firm, and each executive officer s individual experience, performance, responsibility and contribution to the results of the Company s operations, makes compensation recommendations to the Committee for all executive officers other than himself. The Compensation

Committee is free to make adjustments to such recommendations as it deems appropriate.

Although the Compensation Committee relies on compensation data regarding general industry and the energy services industry compiled by Towers Perrin, Towers Perrin does not recommend the amount or form of executive and director compensation. WEC engaged Towers Perrin to provide a variety of compensation-related services, one of which is to provide the compensation data. Towers Perrin was not engaged directly by the Compensation Committee. However, the Committee has unrestricted access to Towers Perrin and may retain its own compensation consultant at its discretion. For more information regarding our executive compensation processes and procedures, please refer to the Compensation Discussion and Analysis later in this proxy statement.

Does the Board have a nominating committee?	Yes, the Corporate Governance Committee is responsible for, among other things, identifying and evaluating director nominees. The chair of the Committee coordinates this effort. The Board has determined that all members of the Corporate Governance Committee are independent under New York Stock Exchange rules applicable to nominating committee members.
What is the process used to identify director nominees and how do I recommend a nominee to the Corporate Governance Committee?	Candidates for director nomination may be proposed by stockholders, the Corporate Governance Committee and other members of the Board. The Committee may pay a third party to identify qualified candidates; however, no such firm was engaged with respect to the nominees listed in this proxy statement. No stockholder nominations or recommendations for director candidates were received.
	Stockholders wishing to propose director candidates for consideration and recommendation by the Corporate Governance Committee for election at the 2010 Annual Meeting of Stockholders must submit the candidates names and qualifications to the Corporate Governance Committee no later than November 2, 2009, via the Corporate Secretary, Susan H. Martin, at the Company s principal business office, 231 West Michigan Street, P.O. Box 1331, Milwaukee, Wisconsin 53201.
What are the criteria and process used to evaluate director nominees?	The Corporate Governance Committee has not established minimum qualifications for director nominees; however, the criteria for evaluating all candidates, which are reviewed annually, include characteristics such as: proven integrity, mature and independent judgment, vision and imagination, ability to objectively appraise problems, ability to evaluate strategic options and risks, sound business experience and acumen, relevant technological, political, economic or social/cultural expertise, social consciousness, achievement of prominence in career, familiarity with national and international issues affecting the Company s businesses, contribution to the Board s desired diversity and balance and availability to serve for five years before reaching the directors retirement age of 72 as set forth in the Company s Corporate Governance Guidelines.
	In evaluating director candidates, the Corporate Governance Committee reviews potential conflicts of interest, including interlocking directorships and substantial business, civic and/or social relationships with other members of the Board that could impair the prospective Board member s ability to act independently from the other Board members and management. The Bylaws state that directors shall be stockholders of WEC.
	Once a person has been identified by the Corporate Governance Committee as a potential candidate, the Committee may collect and review publicly available information regarding the person to assess whether the person should be considered further. If the Committee determines that the candidate warrants further consideration, the chair or another member of the Committee contacts the person. Generally, if the person

expresses a willingness to be considered and to serve on the Board, the Committee requests information from the candidate, reviews the person s accomplishments and qualifications and conducts one or more interviews with the candidate. In certain instances, Committee members may contact one or more references provided by the candidate or may contact other members of the business community or other persons who may have greater firsthand knowledge of the candidate s accomplishments.

The Committee evaluates all candidates, including those proposed by stockholders, using the criteria and process described above. The process is designed to provide the Board with a diversity of experience and stability to allow it to effectively meet the many challenges WEC faces in today s changing business environment.

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What is the deadline for stockholders to submit proposals for the 2010 Annual Meeting of Stockholders?	Stockholders who intend to have a proposal considered for inclusion in the Company s proxy materials for presentation at the 2010 Annual Meeting of Stockholders must submit the proposal to the Company no later than December 3, 2009.
	Stockholders who intend to present a proposal at the 2010 Annual Meeting of Stockholders without inclusion of such proposal in the Company s proxy materials, or who propose to nominate a person for election as a director at the 2010 Annual Meeting, are required to provide notice of such proposal or nomination, containing the information required by the Company s Bylaws, to the Company at least 70 days and not more than 100 days prior to the scheduled date of the 2010 Annual Meeting of Stockholders. The 2010 Annual Meeting of Stockholders is tentatively scheduled for May 6, 2010.
	Correspondence in this regard should be directed to the Corporate Secretary, Susan H. Martin, at the Company s principal business office, 231 West Michigan Street, P.O. Box 1331, Milwaukee, Wisconsin 53201.
What is WEC s policy regarding director attendance at annual meetings?	All directors are expected to attend the Company s annual meetings of stockholders. All current directors attended the 2008 Annual Meeting.
Where can I find more information about WEC corporate governance?	The Company s website, www.wisconsinenergy.com, contains information on the Company s governance activities. The site includes the Code of Business Conduct, Corporate Governance Guidelines, Board committee charters and other useful information. As policies are continually evolving, the Company encourages you to visit the website periodically. Copies of these documents may also be requested in writing from the Corporate Secretary.

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COMMITTEES OF THE BOARD OF DIRECTORS

Members	Principal Responsibilities; Meetings
Audit and Oversight Thomas J. Fischer, Chair John F. Bergstrom Barbara L. Bowles Robert A. Cornog	Oversee the integrity of the financial statements. Oversee management compliance with legal and regulatory requirements. Review, approve and evaluate the independent auditors services. Oversee the performance of the internal audit function and independent auditors. Prepare the report required by the SEC for inclusion in the proxy statement. Establish procedures for the submission of complaints and concerns regarding WEC s accounting or auditing matters. The Committee conducted six meetings in 2008.
Compensation John F. Bergstrom, Chair Ulice Payne, Jr. Frederick P. Stratton, Jr.	Identify through succession planning potential executive officers. Provide a competitive, performance-based executive and director compensation program. Set goals for the CEO, annually evaluate the CEO s performance against such goals and determine compensation adjustments based on whether these goals have been achieved. The Committee conducted six meetings in 2008, including one joint meeting with the Corporate Governance Committee, and executed two signed, written unanimous consents.
Corporate Governance Barbara L. Bowles, Chair	Establish and review the Corporate Governance Guidelines to ensure the Board is effectively performing its fiduciary responsibilities to stockholders.

Robert A. Cornog Curt S. Culver Frederick P. Stratton, Jr.	Identify and recommend candidates to be named as nominees of the Board for election as directors. Lead the Board in its annual review of the Board s performance. The Committee conducted four meetings in 2008, including one joint meeting with the Compensation Committee.
Finance Curt S. Culver, Chair Patricia W. Chadwick Ulice Payne, Jr. Frederick P. Stratton, Jr.	Review and monitor the Company s current and long-range financial policies and strategies, including its capital structure and dividend policy. Authorize the issuance of corporate debt within limits set by the Board. Discuss policies with respect to risk assessment and risk management. Review, approve and monitor the Company s capital and operating budgets. The Committee conducted four meetings in 2008.

The Board also has an Executive Committee which may exercise all powers vested in the Board except action regarding dividends or other distributions to stockholders, filling Board vacancies and other powers which by law may not be delegated to a committee or actions reserved for a committee comprised of independent directors. The members of the Executive Committee are Gale E. Klappa (Chair), John F. Bergstrom, Barbara L. Bowles, Robert A. Cornog and Frederick P. Stratton, Jr. The Executive Committee did not meet in 2008.

In addition to the number of committee meetings listed in the preceding table, the Board met six times in 2008 and executed one signed, written unanimous consent. The average meeting attendance during the year was 92%. No director attended fewer than 81% of the total number of meetings of the Board and Board committees on which he or she served.

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AUDIT AND OVERSIGHT COMMITTEE REPORT

The Audit and Oversight Committee, which is comprised solely of independent directors, oversees the integrity of the financial reporting process on behalf of the Board of Directors of Wisconsin Energy Corporation. In addition, the Committee oversees compliance with legal and regulatory requirements. The Committee operates under a written charter approved by the Board of Directors, which can be found in the Governance section of the Company s website at www.wisconsinenergy.com.

The Committee is also responsible for the appointment, compensation, retention and oversight of the Company s independent auditors, as well as the oversight of the Company s internal audit function. The Committee selected Deloitte & Touche LLP to remain as the Company s independent auditors for 2009, subject to stockholder ratification.

Management is responsible for the Company s financial reporting process, the preparation of consolidated financial statements in accordance with generally accepted accounting principles and the system of internal controls and procedures designed to provide reasonable assurance regarding compliance with accounting standards and applicable laws and regulations. The Company s independent auditors are responsible for performing an independent audit of the Company s consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States) and issuing a report thereon.

The Committee held six meetings during 2008. Meetings are designed to facilitate and encourage open communication among the members of the Committee, management, the internal auditors and the Company s independent auditors, Deloitte & Touche LLP. During these meetings, we reviewed and discussed with management, among other items, the Company s unaudited quarterly and audited annual financial statements and the system of internal controls designed to provide reasonable assurance regarding compliance with accounting standards and applicable laws. We reviewed the financial statements and the system of internal controls with the Company s independent auditors, both with and without management present, and we discussed with Deloitte & Touche LLP matters required by Statement on Auditing Standards No. 114 relating to communications with audit committees, including the quality of the Company s accounting principles, the reasonableness of significant judgments and the clarity of disclosures in the financial statements.

In addition, we received the written disclosures and the letter relative to the auditors independence from Deloitte & Touche LLP, as required by applicable requirements of the Public Company Accounting Oversight Board regarding Deloitte & Touche LLP s communications with the Committee concerning independence. The Committee discussed with Deloitte & Touche LLP its independence and also considered the compatibility of non-audit services provided by Deloitte & Touche LLP with maintaining its independence.

Based on these reviews and discussions, the Audit and Oversight Committee recommended to the Board of Directors that the audited financial statements be included in Wisconsin Energy Corporation s Annual Report on Form 10-K for the fiscal year ended December 31, 2008 and filed with the Securities and Exchange Commission.

Respectfully submitted to Wisconsin Energy Corporation stockholders by the Audit and Oversight Committee of the Board of Directors.

Thomas J. Fischer, Committee Chair
John F. Bergstrom
Barbara L. Bowles
Robert A. Cornog

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COMPENSATION DISCUSSION AND ANALYSIS

General Overview. The primary objective of our executive compensation program is to provide a competitive, performance-based plan that enables the Company to attract and retain key individuals and to motivate them to achieve both the Company s long-term and short-term goals. Our program has been designed to provide a level of compensation that is strongly dependent upon the achievement of goals that are aligned with the interests of our stockholders and customers. As a result, a substantial portion of pay is at risk.

The following discussion provides an overview and analysis of our executive compensation program, including the role of the Compensation Committee of our Board of Directors, the elements of our executive compensation program, the purposes and objectives of these elements and the manner in which we established the compensation of our executive officers for fiscal year 2008.

References to we , us , our and WEC in this discussion and analysis mean Wisconsin Energy Corporation and its management, as applicable.

Compensation Committee. The Compensation Committee of our Board of Directors is responsible for making decisions regarding compensation for executive officers of WEC and its principal subsidiaries and for developing our executive compensation philosophy. The assessment of the Chief Executive Officer s performance and determination of the CEO s compensation are among the principal responsibilities of the Compensation Committee. The Compensation Committee also approves the compensation of each of our other executive officers and recommends the compensation of our Board of Directors, with input from the Corporate Governance Committee, for approval by the Board. In addition, the Compensation Committee administers our long-term incentive compensation programs, including the 1993 Omnibus Stock Incentive Plan, as amended, and the WEC Performance Unit Plan, as amended, which are discussed further below.

The Compensation Committee is comprised solely of directors who are independent directors under our corporate governance guidelines and the rules of the New York Stock Exchange. No member of the Compensation Committee is a current or former employee of WEC or its subsidiaries.

Elements of WEC s Executive Compensation Program. The principal goal of the Compensation Committee is to provide an executive compensation program that is competitive with programs of comparable employers, aligns management s incentives with the short-term and long-term interests of our stockholders and encourages the retention of top performers. To achieve this goal, we compensate executives through a mix of compensation elements that includes:

- annual base salary;
- annual cash incentive compensation (based principally on earnings and cash flow performance);
- long-term incentive compensation through a mix of: (1) stock options; (2) performance units; and (3) dividends on the performance units;
- retirement programs; and
- other employee benefit programs, including a limited number of executive perquisites.

In addition, under our compensation program, each executive officer is entitled to severance compensation if his or her employment is terminated in connection with a change in control of WEC.

With respect to each of these elements, we analyze market data provided by Towers Perrin, a compensation consulting firm retained by management, to determine the appropriate levels of compensation for each named executive officer. A more detailed discussion of each of these elements and the extent to which we analyze market data in establishing each individual element is set forth below. Other than comparing each element of compensation with the appropriate market data and as otherwise described in this Compensation Discussion and Analysis, we do not have any formal policy with respect to the allocation of cash versus non-cash compensation or short-term versus long-term incentive compensation.

Competitive Data. As a general matter, we believe the labor market for WEC executive officers is consistent with that of general industry. Although we recognize our business is focused on the energy services industry, our goal is to have an executive compensation program that will allow us to be competitive in recruiting the most qualified candidates to serve as executive officers of the Company, including individuals who may be employed outside of the energy services industry. Further, in order to retain top performing executive officers, we believe our compensation practices must be competitive with those of general industry.

In order to confirm that our annual executive compensation is competitive with the market, we consider the market data obtained from Towers Perrin. For 2008, Towers Perrin provided us with compensation data from its 2008 Executive Compensation Data Bank, which contains information obtained from approximately 416 companies of varying sizes in a wide range of businesses throughout general industry, including information from approximately 104 companies within the energy services industry (i.e., companies with regulated and/or unregulated utility operations and independent power producers).

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For Messrs. Klappa, Leverett and Fleming, the term market median means the median level for an executive officer serving in a comparable position in a comparably sized company (revenues of $3 billion to $6 billion) in general industry based on our analysis of the Towers Perrin survey data. With respect to Mr. Kuester, given the nature of his position as principal executive officer of our electric utility generation operations, we consider the average of (1) the median level for an individual serving as the top generation officer of a company comparable in size to We Energies (revenues of $3 billion to $6 billion) in the energy services industry and (2) the median level for the chief executive officer in general industry in a business comparable in size to the generation operations of Wisconsin Energy. With respect to Ms. Rappé, given the scope of her responsibilities as Chief Administrative Officer of the Company, we consider the average of (1) the median level for an individual serving as the top administrative officer of a company comparable in size to We Energies in the energy services industry and (2) the median level for the top administrative officer in general industry in a business comparable in size to Wisconsin Energy.

Annual Base Salary. The annual base salary component of our executive compensation program provides each executive officer with a fixed level of annual cash compensation. We believe that providing annual cash compensation through a base salary is an established market practice and is a necessary component of a competitive overall executive compensation program.

In determining the annual base salaries to be paid to our named executive officers, we generally target base salaries to be within 10% of the market median for each named executive officer. However, the Compensation Committee may, in its discretion, adjust base salaries outside of this 10% band when the Committee deems it appropriate. Actual salary determinations in 2008 were made taking into consideration factors such as the relative levels of individual experience, performance, responsibility and contribution to the results of the Company s operations.

With respect to Mr. Klappa, based on the factors described above and the results of the Board s annual CEO evaluation, the Compensation Committee approved an annual base salary of $1,129,008 for 2008, which represented an increase of approximately 5.0% from 2007. This resulted in an annual base salary that was nominally above our target range. The Compensation Committee determined that this was appropriate, recognizing Mr. Klappa s demonstrated leadership abilities, the Company s results in 2007 and the Company s continued achievement of record financial and operational performance.

With respect to each other named executive officer, Mr. Klappa recommended an annual base salary to the Compensation Committee based on a review of market compensation data and the factors described above. The Compensation Committee approved Mr. Klappa s recommendations, which represented an increase in base salary of approximately (i) 5.5% for Messrs. Leverett and Kuester, (ii) 5.0% for Mr. Fleming and (iii) 4.5% for Ms. Rappé over 2007 levels. Mr. Klappa based his recommendations on their pay relative to the comparative data provided by Towers Perrin and each individual s contributions to the overall results of the Company. The annual base salaries of Messrs. Kuester and Fleming, and Ms. Rappé, were within 10% of the appropriate market median. The annual base salary for Mr. Leverett was above our target range. We believe that Mr. Leverett s responsibilities and contributions vary widely from those of his counterparts within general industry, and thus, additional compensation is warranted. In recognition of his significant responsibilities and contributions to the strategic direction of the Company beyond those of a typical principal financial officer, the Compensation Committee approved a higher level of base salary for Mr. Leverett.

In light of the economic conditions in our service territories, the Compensation Committee agreed with Mr. Klappa s recommendation to freeze 2009 salaries at 2008 levels for all officers of the Company and its subsidiaries, including the named executive officers.

Annual Cash Incentive Compensation. We provide annual cash incentive compensation through our Short-Term Performance Plan (STPP). The STPP provides for annual cash awards to named executive officers based upon the achievement of pre-established stockholder, customer and employee focused objectives. All payments under the plan are at risk. Payments are made only if performance goals are achieved, and awards may be less or greater than targeted amounts based on actual performance. Payments under the STPP are intended to reward achievement of short-term goals that contribute to stockholder value, as well as individual contributions to successful operations.

2008 Target Awards. Each year, the Compensation Committee approves a target level of compensation under the STPP for each of our named executive officers. This target level of compensation is expressed as a percentage of base salary. Each of Messrs. Klappa, Leverett and Kuester, and Ms. Rappé, has an employment agreement with WEC that specifies a minimum target level of compensation under the STPP based on a percentage of such executive officer s annual base salary. Under the terms of these employment agreements, the target award may not be adjusted below these minimum levels unless the Board of Directors or Compensation Committee takes action resulting in the lowering of target awards for the entire senior executive group. Mr. Fleming s employment agreement provides for a target level of compensation under the STPP equal to 70% of his annual base salary. The target levels contained in the employment agreements were negotiated and, we believe, consistent with market practice at the time the agreements were entered into. Based upon our annual review of these target levels in 2008, we determined that they continue to be supported by market data.

For 2008, the Compensation Committee approved the following target awards under the STPP for each named executive officer, which are the same as those set forth in their employment agreements:

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Executive Officer	Target STPP Award as a Percentage of Base Salary
Mr. Klappa	100%
Mr. Leverett	80%
Mr. Kuester	80%
Mr. Fleming	70%
Ms. Rappé	60%

For 2008, the possible payout for any named executive officer ranged from 0% of the target award to 210% of the target award, based on our performance.

2008 Performance Goals. The Compensation Committee adopted the 2008 STPP with a continued principal focus on financial results. In December 2007, the Compensation Committee approved the two primary performance measures to be used in 2008: (1) earnings per share from ongoing operations (75% weight); and (2) cash flow (25% weight). We believe these measures are key indicators of financial strength and performance and are recognized as such by the investment community. In January 2008, the Compensation Committee approved threshold level, target level, above target level and maximum payout level performance goals for each of these performance measures under the STPP. If the threshold level, target level, above target level or maximum payout level performance goal was achieved for both performance measures, officers participating in the STPP could receive 50%, 100%, 125% or 200%, respectively, of the target award.

The earnings per share from ongoing operations goals for 2008 were a threshold level goal of $2.75 per share, a target level goal of $2.81 per share, an above target level goal of $2.84 per share and a maximum payout level goal of $2.90 per share. The performance goals for cash flow were set at a threshold level goal of ($448.2) million, a target level goal of ($430.6) million, an above target level goal of ($421.8) million and a maximum payout level goal of ($395.5) million.

The Compensation Committee established the target levels for earnings per share based upon expected earnings growth in 2008 in the utility industry as indicated by other utilities in their published earnings guidance. For example, the target level performance goal was set to approximate the median level of expected earnings growth in the utility industry while the maximum payout level goal would only be earned if the Company s actual earnings per share growth in 2008 exceeded the 75th percentile of expected earnings growth in the utility industry. The Committee projected our 2008 earnings growth off of our year-end earnings per share from continuing operations in 2007. The Committee then established cash flow target levels to correspond to the budget necessary to achieve the same levels of earnings per share performance (i.e., the 100% cash flow target corresponds to the budget necessary to achieve the 100% earnings per share target).

In December 2007 and January 2008, the Compensation Committee also approved operational performance measures and targets under the annual incentive plan. Annual incentive awards could be increased or decreased by up to 10% of the target award based upon the Company s performance in the operational areas of customer satisfaction (5% weight), supplier and workforce diversity (2.5%) and safety (2.5%). Although the Compensation Committee believes the achievement of financial performance goals are necessary, it also recognizes the importance of strong operational results to the success of the Company.

In addition to applying these financial and operational factors, the Compensation Committee retains the right to exercise discretion in adjusting awards under the STPP when it deems appropriate.

2008 Performance Under the STPP. In January 2009, the Compensation Committee reviewed our actual performance for 2008 against the financial and operational performance goals established under the STPP, subject to final audit. In 2008, the Company s financial performance satisfied the maximum payout level goals established for both earnings per share from ongoing operations and cash flow. In 2008, our earnings per share from ongoing operations were $3.03 per share and our cash flow was ($158.9) million. Cash flow is measured by subtracting cash used in investing activities, excluding an investment in our transmission affiliate and net proceeds from asset sales, from cash provided by operations. In addition, when calculating the cash flow measure, we reclassified the $345.1 million of bill credits provided to our customers from the net proceeds of the sale of the Point Beach Nuclear Plant from cash used in investing activities to cash provided by operations. Although generally accepted accounting principles require us to record the bill credits as an investment activity because we are collecting the cash from restricted accounts and not our customers, we consider this as a source of revenue. This reclassification strictly reflects how the Company views the bill credits and did not have any impact on the cash flow measure. Our cash flow measure is not a measure of financial performance under generally accepted accounting principles.

By satisfying the maximum payout level performance goals with respect to both earnings per share from ongoing operations and cash flow, officers participating in the STPP, including the named executive officers, earned 200% of the target award from the financial goal component of the STPP.

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With respect to operational goals in 2008, our performance generated an additional 6.25% based on our achievement in customer satisfaction and supplier diversity. In 2008, the Company s performance exceeded targeted levels with respect to both measures. The Compensation Committee measured customer satisfaction levels based on the results of surveys that an independent third party conducted of customers who had direct contact with the Company during the year, which measured (1) our customers satisfaction with the Company in general and (2) our customers satisfaction with respect to their particular interactions with the Company. With respect to safety measures, although the Company exceeded the target level for lost-time injuries, it did not meet the target level for Occupational Safety and Health Administration (OSHA) recordable injuries, resulting in a neutral impact on the STPP award. The Company also achieved target level performance with respect to workforce diversity, which did not result in a further increase in the STPP award for 2008.

Based on the Company s performance against the financial and operational goals established by the Compensation Committee, Mr. Klappa received annual incentive cash compensation under the STPP of $2,328,579 for 2008. This represented 206.25% of his annual base salary. Messrs. Leverett, Kuester and Fleming, and Ms. Rappé, received annual cash incentive compensation for 2008 under the STPP equal to 165%, 165%, 144.4% and 123.8% of their respective annual base salaries, representing 206.25% of the target award for each officer.

In view of the discretionary component of the annual cash incentive plan, the Compensation Committee also considered other significant accomplishments of the Company in 2008. These included:

- Strong financial performance
  - Record earnings from continuing operations of $3.03 per share.
  - Cash from operations was at an all-time high.
  - A 25% increase in the dividend effective with the first quarter payment in 2009.
  - Debt to total capital ratio of 55.4% at year-end 2008, attributing 50% common equity treatment to our 2007 Series A Junior Subordinated Notes, which we believe is consistent with the treatment given by the majority of rating agencies. The year-end debt to total capital ratio was significantly better than our target of 60.0%.
  - WEC common stock performance for 2008 ranked in the top 20% of all stocks listed in the United States and in the top 15% of major American utilities.
- Operational excellence
  - Continued progress in our *Power the Future* strategic plan; we added more megawatts of new generating capacity than any other year in the Company s history.
  - Continued improvements in customer satisfaction based on customer surveys. Data from 2008 indicated that the Company performed in the top quartile of the industry.
  - Best employee safety record in Company history in 2008, with a 39% reduction in lost-time accidents and a 16% reduction in OSHA recordable injuries.

Best outage restoration times since the Company began keeping records.

Continued leadership and excellence in corporate governance as evidenced by continued receipt during 2008 of a rating of 10, the highest possible score, from GovernanceMetrics International (only one of four companies worldwide to consistently earn this distinction).

Named one of America s 15 best corporate citizens by Corporate Responsibility Officer magazine.

Completed 2008 with our retail electric rates ranking approximately 8% below the national average.

In view of the financial and operational accomplishments and the accomplishments listed above, the Compensation Committee determined that the awards under the STPP were appropriate in relation to our 2008 performance without any further adjustment.

Long-Term Incentive Compensation. The Compensation Committee administers our 1993 Omnibus Stock Incentive Plan which is a stockholder approved, long-term incentive plan designed to link the interests of our executives and other key employees to creating long-term stockholder value. It allows for various types of awards tied to the performance of our common stock, including stock options, stock appreciation rights, restricted stock and performance shares. In 2005, the Compensation Committee approved the Wisconsin Energy Corporation Performance Unit Plan, under which the Compensation Committee may award performance units. The Compensation Committee primarily uses (1) stock options and (2) performance units to deliver long-term incentive opportunities.

Each year, the Compensation Committee makes annual stock option grants as part of our long-term incentive program. These stock options have an exercise price equal to the fair market value of our common stock on the date of grant and expire on the 10th anniversary of the grant date. Since management benefits from a stock option award only to the extent our stock price appreciates

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above the exercise price of the stock option, stock options align the interests of management with those of our stockholders in attaining long-term stock price appreciation.

The Compensation Committee also makes annual grants of performance units under the Performance Unit Plan. The performance units are designed to provide a form of long-term incentive compensation that also aligns the interests of management with those of a typical utility stockholder who is focused not only on stock price appreciation but also on receiving dividend payments. Under the terms of the performance units, payouts are based on the Company s level of total stockholder return (stock price appreciation plus dividends) in comparison to a peer group of companies over a three-year performance period. In addition, each holder of performance units receives a cash dividend when WEC declares a dividend on its common stock in an amount equal to the number of performance units granted to the holder at the target 100% rate multiplied by the amount of the dividend paid on a share of our common stock. The performance units are settled in cash.

Aggregate 2008 Long-Term Incentive Awards. In establishing the target value of long-term incentive awards for each named executive officer in 2008, we analyzed the market compensation data included in the Towers Perrin survey. For Messrs. Klappa and Fleming, and Ms. Rappé, we determined the ratio of (1) the market median value of long-term incentive compensation to (2) the market median level of annual base salary, and multiplied each annual base salary by the applicable market ratio to determine the value of long-term incentive awards to be granted. For Messrs. Leverett and Kuester, we used the average of the results obtained for each to develop a uniform target level of long-term incentive compensation that applied to each officer. We used this method to establish the amount of long-term incentive awards granted to Messrs. Leverett and Kuester as we wanted to establish parity in long-term incentive opportunity between the heads of the financial and key operational areas of the Company because of the critical role each plays in executing the Company s long-term strategy. This target value of long-term incentive compensation for each named executive officer was presented to and approved by the Compensation Committee.

In 2008, the Compensation Committee approved a stock option grant designed to represent approximately two-thirds of the value of the long-term incentive award and a performance unit grant designed to represent approximately one-third of the value of the long-term incentive award. As the market continues to decrease the emphasis on stock options as reflected in the Towers Perrin data, we have increased the size of the performance unit award as a component of our long-term incentive plan and decreased the relative size of the stock option award. For 2009, the Compensation Committee made approximately 72% of the long-term incentive award performance units and approximately 28% stock options. Although the market data provided by Towers Perrin indicates that long-term incentive awards are approximately 60% performance awards and 40% stock options, because of the significant decrease in the Black-Scholes value of our stock options due to market events that occurred in 2008, we would have needed to issue more stock options to meet the 40% level of the long-term incentive award than the Compensation Committee thought was prudent. Therefore, for 2009, the Committee decided to further increase the number of performance awards and decrease the number of stock options granted.

2008 Stock Option Grants. In December 2007, the Compensation Committee approved the grant of stock options to each of our named executive officers and established an overall pool of options that were granted to approximately 135 other employees. These option grants were made effective January 2, 2008, the first trading day of 2008. The options were granted with an exercise price equal to the average of the high and low prices reported on the New York Stock Exchange for shares of WEC common stock on the January 2, 2008 grant date. The options were granted in accordance with our standard practice of making annual stock option grants in January of each year, and the timing of the grants was not tied to the timing of any release of material non-public information. These stock options have a term of 10 years and vest 100% on the third anniversary of the date of grant. The vesting of the stock options may be accelerated in connection with a change in control or an executive officer s termination of employment. See Potential Payments upon Termination or Change in Control under Executive Officers Compensation for additional information.

For purposes of determining the appropriate number of options to grant to a particular named executive officer, the value of an option was determined based on the Black-Scholes option pricing model. We use the Black-Scholes option pricing model for purposes of the compensation valuation primarily because the market information we review from Towers Perrin calculates the value of option awards on this basis. The following table provides the number of options granted to each named executive officer.

Executive Officer	**Options Granted**
Mr. Klappa	300,000
Mr. Leverett	164,250
Mr. Kuester	164,250
Mr. Fleming	61,500

Ms. Rappé	50,200

For financial reporting purposes under SFAS 123R, the stock options granted in 2008 had a grant date fair value of $10.48 per option for Messrs. Klappa, Leverett and Kuester, and Ms. Rappé, and a grant date fair value of $8.29 for Mr. Fleming. Mr. Fleming is

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considered to be retirement eligible. Therefore his options are presumed to have a shorter expected life than the other named executive officers, which results in a lower option value.

2008 Performance Units. In 2008, the Compensation Committee granted performance units to each of our named executive officers and approved a pool of performance units that were granted to approximately 135 other employees. With respect to the 2008 performance units, the amount of the benefit that ultimately vests will be dependent upon the Company s total stockholder return over a three-year period ending December 31, 2010, as compared to the total stockholder return of a custom peer group of companies described below. Total stockholder return is the calculation of total return (stock price appreciation plus reinvestment of dividends) based upon an initial investment of $100 and subsequent $100 investments at the end of each quarter during the three-year performance period.

Upon vesting, the performance units will be settled in cash in an amount determined by multiplying the number of performance units that have vested by the closing price of the Company s common stock on the last trading day of the performance period.

The peer group used for purposes of the performance units is comprised of: Allegheny Energy, Inc.; Alliant Energy Corporation; Ameren Corporation; American Electric Power Company, Inc.; Avista Corporation; Consolidated Edison, Inc.; DTE Energy Company; Duke Energy Corp.; FirstEnergy Corp.; Great Plains Energy; Integrys Energy Group, Inc.; NiSource Inc.; Northeast Utilities; Nstar; OGE Energy Corp.; Pinnacle West Capital Corporation; Pepco Holdings, Inc.; PG&E Corporation; Portland General; Progress Energy Inc.; SCANA Corporation; Sempra Energy; Sierra Pacific Resources (n/k/a NV Energy, Inc.); The Southern Company; Westar Energy, Inc.; Wisconsin Energy Corporation; and Xcel Energy Inc. This peer group was chosen because we believe these companies are similar to WEC in terms of business model and long-term strategies.

The required performance percentile rank and the applicable vesting percentage are set forth in the chart below.

Performance Percentile Rank	**Vesting Percent**
< 25th Percentile	0%
25th Percentile	25%
Target (50th Percentile)	100%
75th Percentile	125%
90th Percentile	175%

If the Company s rank is between the benchmarks identified above, the vesting percentage will be determined by interpolating the appropriate vesting percentage. Unvested performance units generally are immediately forfeited upon a named executive officer s cessation of employment with WEC prior to completion of the three-year performance period. However, the performance units will vest immediately at the target 100% rate upon (1) the termination of the named executive officer s employment by reason of disability or death or (2) a change in control of WEC while the named executive officer is employed by WEC. In addition, a prorated number of performance units (based upon the target 100% rate) will vest upon the termination of employment of the named executive officer by reason of retirement prior to the end of the three-year performance period.

For purposes of determining the appropriate number of performance units to grant to a particular named executive officer, the value of a unit was determined based on an assumed approximate value of $47.88 per unit. The assumed approximate value was based on trading prices on October 31, 2007 as we were analyzing target compensation levels for 2008 during October and November 2007. The following table provides the number of units granted to each named executive officer at the 100% target level.

Executive Officer	**Performance Units Granted**
Mr. Klappa	30,000
Mr. Leverett	15,850
Mr. Kuester	15,850
Mr. Fleming	6,100
Ms. Rappé	4,850

For financial reporting purposes under SFAS 123R, the performance units granted to the above named executive officers in 2008 had a grant date fair value of $47.80 per unit.

2008 Payouts Under Previously Granted Long-Term Incentive Awards. In 2006, the Compensation Committee granted performance unit awards to participants in the plan, including the named executive officers. The terms of the performance units granted in 2006

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were substantially similar to those of the performance units granted in 2008 described above. The required performance percentile ranks and related vesting schedule were identical to that of the 2008 units described above.

Payouts under the 2006 performance units were based on our total stockholder return for the three-year performance period ended December 31, 2008 against substantially the same group of peer companies used for the 2008 performance unit awards, except that the peer group of companies for the 2006 award (i) included Entergy Corporation, Exelon Corporation, FPL Group, Inc., Public Service Enterprise Group Incorporated and Puget Energy, Inc., and (ii) excluded Great Plains Energy, PG&E Corporation and Portland General. Energy East Corporation, which was originally part of the 2006 peer group, was purchased by a foreign utility holding company and is no longer a public company. Therefore, we are unable to measure its total stockholder return. In October 2007, Puget Energy announced that it was entering into a merger agreement. There was a subsequent increase in its stock price related to this announcement, which we believe was not the result of ongoing operating performance. Puget Energy s common stock performance continues to reflect this extraordinary event. Therefore, the Compensation Committee modified the peer group established for the 2006 performance unit grant to exclude Puget Energy. The Compensation Committee believes our total stockholder return should be compared to the total stockholder return of companies whose results are based on operating performance and not extraordinary events. Therefore, the Committee excluded Puget Energy even though such exclusion caused the payout under the 2006 performance unit grant to increase.

For the three-year performance period ended December 31, 2008, our total stockholder return was at approximately the 85th percentile of the peer group (excluding Puget Energy), resulting in the performance units vesting at a level of 159.0%. If Puget Energy were included in the calculation, our total stockholder return would have been at approximately the 82nd percentile of the peer group, which would have resulted in the performance units vesting at a level of 148.8%. The actual payouts were determined by multiplying the number of vested performance units by the closing price of our common stock ($41.98) on December 31, 2008, the last trading day of the performance period. The actual payout to each named executive officer is reflected in the Option Exercises and Stock Vested for Fiscal Year 2008 table below. This table also reflects amounts realized by any named executive officer in connection with the exercise in 2008 of any vested stock options and the amounts realized by any named executive officer in connection with the vesting of previously granted restricted stock. For information on other outstanding equity awards held by our named executive officers at December 31, 2008, please refer to the table entitled Outstanding Equity Awards at Fiscal Year-End 2008 below.

Stock Ownership Guidelines. The Compensation Committee believes that an important adjunct to the long-term incentive program is significant stock ownership by officers who participate in the program, including the named executive officers. Accordingly, the Compensation Committee has implemented stock ownership guidelines for officers of the Company. These guidelines provide that each executive officer should, over time (generally within five years of appointment as an executive officer), acquire and hold Company common stock having a minimum fair market value ranging from 150% to 300% of base salary. In addition to certificated shares, holdings of each of the following are included in determining compliance with our stock ownership guidelines: restricted stock; WEC phantom stock units held in the Executive Deferred Compensation Plan; WEC stock held in the 401(k) plan; performance units at target; vested stock options; shares held in our dividend reinvestment plan; and shares held by a brokerage account, jointly with an immediate family member or in a trust.

Policy Regarding Hedging the Economic Risk of Stock Ownership. Certain forms of hedging or monetization transactions, such as zero-cost collars and forward sale contracts, allow a director, officer or employee to lock in much of the value of his or her stock holdings, often in exchange for all or part of the potential for upside appreciation in the stock. These transactions allow the director, officer or employee to continue to own the covered securities, but without the full risks and rewards of ownership. When that occurs, the director, officer or employee may no longer have the same objectives as our other stockholders. Therefore, we have a policy under which directors, officers and employees are prohibited from engaging in any such transactions.

Analysis of Aggregate Salary, Annual Incentive and Long-Term Incentive Compensation. The discussion above describes the manner in which we determined the (1) annual base salary, (2) target level annual cash incentive compensation and (3) long-term incentive compensation awards for each named executive officer. As we developed preliminary target compensation levels for each of these elements of total compensation, we compared the aggregate amount of these elements to the market compensation data. The purpose of this review was to confirm that the aggregate targeted compensation did not deviate significantly from market medians.

Retirement Programs. We also maintain four different retirement plans in which our named executive officers participate: a defined benefit pension plan of the cash balance type, two supplemental executive retirement plans and individual letter agreements with each of the named executive officers. We believe our retirement plans are a valuable benefit in the attraction and retention of our employees, including our executive officers. We believe that providing a foundation for long-term financial security for our employees, beyond their employment with the Company, is a valuable component of our overall compensation program which will inspire increased loyalty and improved performance. For more information about our retirement plans, see Pension Benefits at Fiscal Year-End 2008 and Retirement Plans later in this proxy statement.

Other Benefits, Including Perquisites. The Company provides its executive officers with employee benefits and a limited number of perquisites. Except as specifically noted elsewhere in this proxy statement, the employee benefits programs in which executive

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officers participate (which provide benefits such as medical benefits coverage, retirement benefits and annual contributions to a qualified savings plan) are generally the same programs offered to substantially all of the Company s salaried employees.

The perquisites made available to executive officers include the availability of financial planning, limited spousal travel, membership in a service that provides health care and safety management when traveling outside the United States and payment of the cost of a mandatory physical exam that the Board requires annually. The Company also pays periodic dues and fees for certain club memberships for the named executive officers and other designated officers. In addition, executive officers receive tax gross-ups to reimburse the officer for certain tax liabilities. For a more detailed discussion of perquisites made available to our named executive officers, please refer to the notes following the Summary Compensation Table below.

We periodically review market data regarding executive perquisite practices. We reviewed a survey conducted by The Ayco Company, L.P., a financial services firm (AYCO), in 2007 of 272 companies throughout general industry. Based upon this review, we believe that the perquisites we provide to our executive officers are generally market competitive. AYCO only conducts this survey bi-annually, so the 2007 survey was the most recent information available. We reimburse executives for taxes paid on income attributable to the financial planning benefits provided to our executives only if the executive uses the Company s identified preferred provider, AYCO. We believe the use of our preferred financial adviser provides administrative benefits and eases communication between Company personnel and the financial adviser. We pay periodic dues and fees for certain club memberships as we have found that the use of these facilities helps foster better customer relationships. Officers, including the named executive officers, are expected to use clubs for which the Company pays dues primarily for business purposes. We do not pay any additional expenses incurred for personal use of these facilities, and officers are required to reimburse the Company to the extent that it pays for any such personal use. The total annual club dues are included in the Summary Compensation Table. We do not permit personal use of the airplane in which the Company owns a partial interest. We do allow spousal travel if an executive s spouse is accompanying the executive on business travel and the airplane is not fully utilized by Company personnel. There is no incremental cost to the Company for this travel, other than the reimbursement for taxes paid on imputed income attributable to the executives for this perquisite, as the airplane cost is the same regardless of whether an executive s spouse travels.

In addition, each of our executive officers participates in a death benefit only plan. Under the terms of the plan, upon an executive officer s death a benefit is paid to his or her designated beneficiary in an amount equal to the after-tax value of three times the officer s base salary if the officer is employed by WEC at the time of death or the after-tax value of one times final base salary if death occurs post-retirement.

Severance Benefits and Change in Control. Competitive practices dictate that companies should provide reasonable severance benefits to employees. In addition, we believe it is important to provide protections to our executive officers in connection with a change in control of WEC. Our belief is that the interests of stockholders will be best served if the interests of our executive officers are aligned with them, and providing change in control benefits should eliminate, or at least reduce, the reluctance of management to pursue potential change in control transactions that may be in the best interests of stockholders.

Each of Messrs. Klappa, Leverett, Kuester and Fleming, and Ms. Rappé, has an employment agreement with the Company, which includes change in control and severance provisions. Under the terms of these agreements, the applicable named executive officer is entitled to certain benefits in the event of a termination of employment. In the event of a termination of employment (1) by us for any reason other than cause, death or disability in anticipation of or following a change in control, (2) by the applicable executive officer for good reason in connection with or in anticipation of a change in control or (3) by the applicable executive officer after completing one year of service following a change in control, each named executive officer is generally entitled to:

- A lump sum payment equal to three times: (1) the highest annual base salary in effect during the last three years and (2) the higher of the current year target bonus amount or the highest bonus paid in any of the last three years (except for Ms. Rappé, whose payment is based upon the current year target bonus amount);

- A lump sum payment assuming three years of additional credited service under the qualified and non-qualified retirement plans based upon the higher of (1) the annual base salary in effect at the time of termination and (2) any salary in effect during the 180 day period preceding the termination date, plus the highest bonus amount (except for Ms. Rappé, whose payment is based upon the current year target bonus amount);

- A lump sum payment equal to the value of three additional years of Company match in the 401(k) plan and the WEC Executive Deferred Compensation Plan;
- Continuation of health and certain other welfare benefit coverage for three years following termination of employment;
- Full vesting of stock options, restricted stock and performance units;
- Financial planning services and other benefits; and
- A gross-up payment should any payments trigger federal excise taxes.

In the absence of a change in control, if we terminate the employment of the applicable executive officer for any reason other than cause, death or disability, or the applicable executive officer terminates his or her employment for good reason, the payments to the applicable named executive officer will be the same as those described above, except that with respect to Messrs. Leverett, Kuester

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and Fleming, and Ms. Rappé, (1) the multiple for the lump sum payment in the first bullet point will be reduced to two, (2) the number of additional years of credited service for qualified and non-qualified retirement plans will be two, (3) the number of additional years of matching in the 401(k) plan and the Executive Deferred Compensation Plan will be two, and (4) health and certain other welfare benefits will continue for two years following termination of employment.

We believe the amounts payable under these agreements are consistent with market standards as confirmed by our periodic analysis of data provided by Towers Perrin. The amounts payable under these arrangements were last reviewed by the Compensation Committee in 2008 and compared to market data provided by Towers Perrin in 2007.

In addition, our supplemental pension plan provides that in the event of a change in control, each named executive officer will be entitled to a lump sum payment of amounts due under the plan if employment is terminated within 18 months of the change in control.

For a more detailed discussion of the benefits and tables that describe payouts under various termination scenarios, see Potential Payments upon Termination or Change in Control later in this proxy statement.

Impact of Prior Compensation. The Compensation Committee did not consider the amounts realized or realizable from prior incentive compensation awards in establishing the levels of short-term and long-term incentive compensation for 2008.

Section 162(m) of the Internal Revenue Code. Section 162(m) of the Internal Revenue Code limits the deductibility of certain executives compensation that exceeds $1 million per year, unless the compensation is performance-based under Section 162(m) and is issued through a plan that has been approved by stockholders. Although the Compensation Committee takes into consideration the provisions of Section 162(m), maintaining tax deductibility is but one consideration among many in the design of our executive compensation program.

With respect to 2008 compensation for the named executive officers, the annual stock option grants under the 1993 Omnibus Stock Incentive Plan have been structured to qualify as performance-based compensation under Section 162(m). Annual cash incentive awards under the STPP and performance units under the Performance Unit Plan do not qualify for tax deductibility under Section 162(m).

409A Amendments to Executive Arrangements. On October 29, 2008, the Compensation Committee authorized and approved amendments to certain executive compensation arrangements for our named executive officers and directors in order to bring such arrangements into documentary compliance with Section 409A of the Internal Revenue Code of 1986, as amended, and corresponding regulations (collectively, Section 409A). The amendments are generally technical in nature and affect the timing, but not the amount, of benefits payable to the named executive officers or directors.

As part of the actions taken by the Compensation Committee, the Wisconsin Energy Corporation Executive Deferred Compensation Plan (the Legacy EDCP), the Wisconsin Energy Corporation Directors Deferred Compensation Plan (the Legacy DDCP) and the Wisconsin Energy Corporation Supplemental Executive Retirement Plan (the Legacy SERP) were renamed and amended effective as of January 1, 2005 to (i) provide that amounts earned, deferred, vested, credited and/or accrued under such plans as of December 31, 2004 are preserved and frozen so that such amounts are exempt from Section 409A, and (ii) provide that no new employees (or directors for the Legacy DDCP) may participate in these plans as of January 1, 2005. The Compensation Committee also adopted new deferred compensation plans effective January 1, 2005 which offer features substantially similar to the Legacy EDCP, Legacy DDCP and Legacy SERP, but with changes necessary to comply with Section 409A.

In addition, the following plans and agreements were also amended and restated as of the dates indicated below to bring them into documentary compliance with Section 409A:

- Wisconsin Energy Corporation Short-Term Performance Plan (effective January 1, 2005);
- Amended and Restated Wisconsin Energy Corporation Executive Severance Policy (effective January 1, 2008);
- Wisconsin Energy Corporation Omnibus Stock Incentive Plan (effective January 1, 2008);

Wisconsin Energy Corporation Performance Unit Plan (effective October 11, 2007);

Amended and Restated Senior Officer and Non-Compete Agreement between Wisconsin Energy Corporation and Gale E. Klappa (effective January 1, 2005);

Senior Officer Employment and Non-Compete Agreement between Wisconsin Energy Corporation and Allen L. Leverett (effective January 1, 2005);

Senior Officer Employment and Non-Compete Agreement between Wisconsin Energy Corporation and Frederick D. Kuester (effective January 1, 2005);

Letter Agreement by and between Wisconsin Energy Corporation and James C. Fleming (effective November 23, 2005); and

Amended and Restated Senior Officer, Change in Control, Severance and Non-Compete Agreement between Wisconsin Energy Corporation and Kristine A. Rappé (effective January 1, 2008).

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COMPENSATION COMMITTEE REPORT

The Compensation Committee has reviewed and discussed the Compensation Discussion and Analysis required by Item 402(b) of Regulation S-K with management and, based on such review and discussions, the Compensation Committee recommended to the Board of Directors that the Compensation Discussion and Analysis be included in this proxy statement.

The Compensation Committee

John F. Bergstrom, Committee Chair
Ulice Payne, Jr.
Frederick P. Stratton, Jr.

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EXECUTIVE OFFICERS COMPENSATION

The following table summarizes total compensation awarded to, earned by or paid to WEC s Chief Executive Officer, Chief Financial Officer and each of WEC s other three most highly compensated executive officers (the named executive officers) during 2008, 2007 and 2006.

Summary Compensation Table

(a) Name and Principal Position	(b) Year	(c) Salary ($)	(d) Bonus ($)	(e) Stock Awards (2) ($)	(f) Option Awards (2) ($)	(g) Non-Equity Incentive Plan Compensation (3) ($)	(h) Change in Pension Value and Nonqualified Deferred Compensation Earnings (4) ($)	(i) All Other Compensation (11) (12) ($)	(j) Total ($)
Gale E. Klappa	2008	1,129,008		2,310,259	2,517,800	2,328,579	1,328,616 (5)	261,040	9,875,302
	2007	1,075,356		1,338,713	2,246,334	2,177,596	4,700,118 (5)	223,749	11,761,866
Chairman of the Board, President and Chief Executive Officer of WEC, WE and WG	2006	1,005,000		1,392,112	1,422,493	2,060,250	1,838,928 (5)	209,828	7,928,611
Allen L. Leverett	2008	607,680		1,082,379	1,209,456	1,002,672	88,151 (6)	101,049	4,091,387
	2007	576,000		610,603	913,011	933,120	197,018 (6)	84,733	3,314,485
Executive Vice President and Chief Financial Officer of WEC, WE and WG	2006	538,200		767,686	520,850	882,648	(7)	79,542	2,788,926
Frederick D. Kuester	2008	657,000		1,101,916	1,209,456	1,084,050	927,165 (8)	136,983	5,116,570
	2007	622,752		630,140	913,011	1,008,859	2,650,828 (8)	110,334	5,935,924
Executive Vice President of WEC and WG; Executive Vice President and Chief Operating Officer of WE	2006	582,000		787,223	520,850	954,480	689,533 (8)	116,210	3,650,296
James C. Fleming	2008	441,000		551,615	889,045	636,694	219,296 (9)	76,298	2,813,948
	2007	420,000		250,780	379,210	595,350	177,938 (9)	66,315	1,889,593
	2006	400,008	150,000	145,153	192,250	574,012	147,488 (9)	271,484	1,880,395
Executive Vice President and General Counsel of WEC, WE									

and WG

Kristine A. Rappé [1]	2008	393,708	432,725	471,479	487,214	252,329 (10)	119,066	2,156,521
Senior Vice President and Chief Administrative Officer of WEC, WE and WG	2007	376,752	288,896	476,379	457,753	438,017 (10)	61,188	2,098,985

(1) Ms. Rappé became a named executive officer in 2007 and, therefore, no information has been provided for 2006.

(2) For 2008, the amounts reported reflect the amounts recognized for financial statement reporting purposes during 2008 in our 2008 consolidated financial statements in accordance with SFAS 123R for stock option awards and performance unit awards made in 2006, 2007 and 2008 and various restricted stock grants that have not yet vested. For 2007, the amounts reported reflect the amounts recognized for financial statement reporting purposes during 2007 in our 2007 consolidated financial statements in accordance with SFAS 123R for stock option awards and performance unit awards made in 2005, 2006 and 2007 and various restricted stock grants that had not yet vested. For 2006, the amounts reported reflect the amounts recognized for financial statement reporting purposes during 2006 in our 2006 consolidated financial statements in accordance with SFAS 123R for stock option awards and performance unit awards made in 2005 and 2006, performance share awards made in 2004 and various restricted stock grants that had not yet vested. The expenses related to performance units/shares and restricted stock are reflected in column (e) above, and the expenses related to stock options are reflected in column (f) above. The actual value received by the executives from these awards may range from $0 to greater than the reported amounts recognized for financial statement reporting purposes, depending upon Company performance and the executive s number of additional years of service with the Company. In accordance with Item 402 of Regulation S-K, the amounts reported in the table above do not reflect the amount of estimated forfeitures related to service-based vesting conditions used for financial reporting purposes. In accordance with SFAS 123R, we made certain assumptions in our valuation of the stock options, the performance units/shares and the restricted stock for financial reporting purposes. See Stock Options in Note A Summary of Significant Accounting Policies and Note J Common Equity in the Notes to Consolidated Financial Statements in our 2008, 2007 and 2006 Annual Reports on Form 10-K for a description of these assumptions. For 2008, the assumptions made in connection with the valuation of the stock options are the same as described in Note A in our 2008 Annual Report, except that the expected life of the options is 4.8 years for Mr. Fleming and 7.3 years for the rest of the named executive officers and the expected forfeiture rate is 0%. The change in

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the expected life of the options to 4.8 years for Mr. Fleming and 7.3 years for the rest of the named executive officers from 6.7 years, as set forth in Note A, resulted from the fact that Mr. Fleming was retirement eligible as of December 31, 2008, and none of the other named executive officers were, whereas the assumption described in Note A is a weighted average of all option holders. The change in the expected forfeiture rate to 0% from 2.0%, as set forth in Note A, is due to the assumption that the named executive officers will not forfeit any of their stock options.

For 2007, the assumptions made in connection with the valuation of stock options are the same as described in Note A in our 2008 Annual Report, except that the expected life of the options is 6.5 years for the named executive officers. The change in the expected life of the options to 6.5 years for the named executive officers from 6.0 years, as set forth in Note A, resulted from the fact that none of the named executive officers were retirement eligible as of December 31, 2007, while the assumption described in Note A is a weighted average of all option holders, some of who were retirement eligible.

For 2006, the assumptions made in connection with the valuation of the stock options are the same as described in Note A in our 2008 Annual Report, except that the expected life of the options is 6.5 years. The change in the expected life of the options to 6.5 years from 6.3 years, as set forth in Note A, resulted from the fact that none of the named executive officers were retirement eligible as of December 31, 2006, whereas the assumption in Note A is a weighted average of all option holders, some of who were retirement eligible.

The reported amounts for 2008 include expenses attributable to stock options and unvested stock awards granted in prior years, respectively, for each named executive officer as follows: Mr. Klappa $1,469,800 and $1,890,459; Mr. Leverett $635,676 and $860,585; Mr. Kuester $635,676 and $880,122; Mr. Fleming $379,210 and $466,256; and Ms. Rappé $296,114 and $364,857. For additional information regarding the value of option awards and stock awards granted in 2008, see column (l) in Grants of Plan-Based Awards for Fiscal Year 2008.

The reported amounts for 2007 include expenses attributable to stock options and unvested stock awards granted prior to 2007, respectively, for each named executive officer as follows: Mr. Klappa $1,422,494 and $900,323; Mr. Leverett $520,851 and $403,585; Mr. Kuester $520,851 and $423,122; Mr. Fleming $192,250 and $151,736; and Ms. Rappé $328,939 and $210,960.

The reported amounts for 2006 include expenses attributable to stock options and unvested stock awards granted prior to 2006, respectively, for each named executive officer as follows: Mr. Klappa $776,533 and $923,840; Mr. Leverett $277,333 and $565,190; Mr. Kuester $277,333 and $584,727; and Mr. Fleming $0 and $0. In December 2004, the Compensation Committee approved the acceleration of vesting of all unvested options awarded, including those awarded to executive officers, in 2002, 2003 and 2004 in anticipation of the impact of adoption of SFAS 123R. Therefore, the amounts reported for 2006 only reflect compensation expense for two years of option awards (2005 and 2006).

(3) Consists of amounts earned under Wisconsin Energy s Short-Term Performance Plan for 2008, 2007 and 2006. See Note (2) under Grants of Plan-Based Awards for Fiscal Year 2008 for a description of the terms of the 2008 awards.

(4) The amounts reported for 2008, 2007 and 2006 reflect the aggregate change in the actuarial present value of each named executive officer s accumulated benefit under all defined benefit plans from December 31, 2007 to December 31, 2008, December 31, 2006 to December 31, 2007 and December 31, 2005 to December 31, 2006, respectively. The named executive officers did not receive any above-market or preferential earnings on deferred compensation in 2008, 2007 or 2006.

(5) The change in the actuarial present value of Mr. Klappa s pension benefit does not constitute a cash payment to Mr. Klappa. Wisconsin Energy s pension benefit obligations to Mr. Klappa will be offset by pension benefits Mr. Klappa is entitled to receive from a prior employer for nearly 29 years of service. The amount reported for Mr. Klappa represents only Wisconsin Energy s obligation of the aggregate change in the actuarial present value of Mr. Klappa s accumulated benefit under all defined benefit plans. Based on information received from the prior employer, we have estimated the portion of Mr. Klappa s total accumulated pension benefit for which Wisconsin Energy will be responsible. If Mr. Klappa s prior employer becomes unable to pay its portion of his accumulated pension benefit, Wisconsin Energy is obligated to pay the total amount.

For 2008, the total aggregate change in the actuarial present value of Mr. Klappa s accumulated benefit was $1,347,101 - $18,485 of which we estimate the prior employer is obligated to pay.

For 2007, the total aggregate change in the actuarial present value of Mr. Klappa s accumulated benefit was $5,080,365 $380,247 of which we estimate the prior employer was obligated to pay. A significant reason for the increase in Mr. Klappa s benefit in 2007 was the result of his years of credited service going from 29.33 to 30.33. At 30 years of service, WEC s pension plan pays an unreduced benefit for all employees who retire at or after age 62 as opposed to age 65. Therefore, beginning in 2007, Mr. Klappa s accumulated benefit was calculated assuming he begins receiving benefits at age 62 rather than age 65. The increase in actuarial present value related to the change in the unreduced benefit date was $2,537,230.

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For 2006, the total aggregate change in the actuarial present value of Mr. Klappa s accumulated benefit was $1,970,360 $131,432 of which we estimate the prior employer was obligated to pay.

(6) The change in the actuarial present value of Mr. Leverett s pension benefit does not constitute a cash payment to Mr. Leverett. Wisconsin Energy s pension benefit obligations to Mr. Leverett will be offset by pension benefits Mr. Leverett is entitled to receive from a prior employer for approximately 15 years of service. The amount reported for Mr. Leverett represents only Wisconsin Energy s obligation of the aggregate change in the actuarial present value of Mr. Leverett s accumulated benefit under all defined benefit plans. Based on information received from the prior employer, we have estimated the portion of Mr. Leverett s total accumulated pension benefit for which Wisconsin Energy will be responsible. If Mr. Leverett s prior employer becomes unable to pay its portion of Mr. Leverett s accumulated pension benefit, Wisconsin Energy is obligated to pay the total amount. For 2008, the total aggregate change in the actuarial present value of Mr. Leverett s accumulated benefit was $75,252. However, because the change in the actuarial present value of his prior employer s obligation decreased by ($12,899) in 2008, Wisconsin Energy s obligation for the aggregate change in the actuarial present value of Mr. Leverett s total accumulated pension benefit is actually $88,151 for 2008.

For 2007, the total aggregate change in the actuarial present value of Mr. Leverett s accumulated benefit was $190,462. However, because the change in the actuarial present value of his prior employer s obligation decreased by ($6,556) in 2007, Wisconsin Energy s obligation for the aggregate change in the actuarial present value of Mr. Leverett s total accumulated pension benefit was actually $197,018 for 2007.

(7) A change in the assumptions used to calculate the actuarial present values under Wisconsin Energy s defined benefit plans as a result of a change in the tax laws caused Mr. Leverett s reported amount to be negative in 2006. The tax laws no longer allowed for an acceleration of nonqualified retirement benefits, and therefore our actuarial valuation began to assume a life annuity rather than a lump sum payment for the nonqualified benefits. The discount rate used to measure the actuarial present value under the nonqualified plans changed to 5.75% from 4.68%. The change affected all named executive officers, but only Mr. Leverett s balance was small enough to result in a negative change in present value. This change in assumptions did not constitute a plan change. The aggregate change in the actuarial present value of Mr. Leverett s accumulated benefit in 2006 under all defined benefit plans was ($109,950).

(8) The change in the actuarial present value of Mr. Kuester s pension benefit does not constitute a cash payment to Mr. Kuester. Wisconsin Energy s pension benefit obligations to Mr. Kuester will be offset by pension benefits Mr. Kuester is entitled to receive from a prior employer for nearly 32 years of service. The amount reported for Mr. Kuester represents only Wisconsin Energy s obligation of the aggregate change in the actuarial present value of Mr. Kuester s accumulated benefit under all defined benefit plans. Based on information received from the prior employer, we have estimated the portion of Mr. Kuester s total accumulated pension benefit for which Wisconsin Energy will be responsible. If Mr. Kuester s prior employer becomes unable to pay its portion of Mr. Kuester s accumulated pension benefit, Wisconsin Energy is obligated to pay the total amount.

For 2008, the total aggregate change in the actuarial present value of Mr. Kuester s accumulated benefit was $958,973 $31,808 of which we estimate the prior employer is obligated to pay.

For 2007, the total aggregate change in the actuarial present value of Mr. Kuester s accumulated benefit was $2,865,319 $214,491 of which we estimate the prior employer was obligated to pay. A significant reason for the increase in Mr. Kuester s benefit in 2007 was the result of his years of credited service going from 34.33 to 35.33. At 35 years of service, the WEC pension plan pays an unreduced benefit for all employees who retire at or after age 60 as opposed to age 62. Therefore, beginning in 2007, Mr. Kuester s accumulated benefit was calculated assuming he begins receiving benefits at age 60 rather than 62. The increase in actuarial present value related to the change in the unreduced benefit date was $1,065,601.

For 2006, the total aggregate change in the actuarial present value of Mr. Kuester s accumulated benefit was $802,868 $113,335 of which we estimate the prior employer was obligated to pay.

(9) The change in the actuarial present value of Mr. Fleming s pension benefit does not constitute a cash payment to Mr. Fleming. Mr. Fleming participates in Wisconsin Energy s qualified pension plan and supplemental executive retirement plan. In addition, Mr. Fleming is entitled to a special supplemental pension account. The present value of the amounts credited to this account is $125,177 for 2008, $122,305 for 2007 and $126,418 for 2006, which will be paid upon termination of employment after age 65. See Pension Benefits at Fiscal Year-End 2008 and Retirement Plans later in this proxy statement for additional details.

(10) The change in the actuarial present value of Ms. Rappé s pension benefit does not constitute a cash payment to Ms. Rappé.

(11) During 2008, each named executive received financial planning services and the cost of an annual physical exam; Messrs. Klappa, Leverett and Fleming, and Ms. Rappé, received reimbursement for club dues; and Messrs. Klappa, Leverett and Kuester were provided with membership in a service that provides healthcare and safety management when traveling outside the United States. In addition, the named executives were eligible to receive reimbursement for taxes paid on imputed income

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attributable to certain perquisites including spousal travel and related costs for industry events where it is customary and expected that officers attend with their spouses. Mr. Klappa was the only named executive who utilized the benefit of spousal travel and any associated tax reimbursement during 2008. These tax reimbursements are reflected separately in the Summary Compensation Table (see the third bullet point in Note 12 below). Other than the tax reimbursement, there is no incremental cost to the Company related to this spousal travel.

(12) We maintain a Death Benefit Only Plan. Pursuant to the terms of the Plan, upon an officer s death a benefit is paid to his or her designated beneficiary in an amount equal to the after-tax value of three times the officer s base salary if the officer is employed by Wisconsin Energy at the time of death or the after-tax value of one times final base salary if death occurs post-retirement. We recognized expenses for the Death Benefit Only Plan as follows in 2008: Mr. Klappa ($74,547), Mr. Leverett ($15,676), Mr. Kuester ($46,644), Mr. Fleming ($12,047) and Ms. Rappé ($14,901).

For Mr. Klappa, the amount reported in All Other Compensation for 2008 includes $15,481 attributable to Wisconsin Energy s Directors Charitable Awards Program in connection with Mr. Klappa s service on the Company s Board of Directors. See Director Compensation for a description of the Directors Charitable Awards Program.

In addition to the perquisites and amounts recognized under the Death Benefit Only Plan and Directors Charitable Awards Program identified above, All Other Compensation for Messrs. Klappa, Leverett, Kuester and Fleming, and Ms. Rappé, for 2008 consists of:

- Employer matching of contributions into the 401(k) plan in the amount of $9,200 for Messrs. Klappa, Kuester and Fleming, and Ms. Rappé, and $8,900 for Mr. Leverett;

- Make-whole payments under the Executive Deferred Compensation Plan that provides a match at the same level as the 401(k) plan (4% for up to 7% of wages) for all deferred salary and bonus not otherwise eligible for a match in the amounts of $112,476, $48,066, $57,734, $31,084 and $22,870, respectively; and

- Tax reimbursements or gross-ups for all applicable perquisites in the amounts of $22,178, $9,653, $5,765, $8,172 and $19,006, respectively.

Percentages of Total Compensation.

For Messrs. Klappa, Leverett, Kuester, and Fleming, and Ms. Rappé, (1) salary (as reflected in column (c) above) represented approximately 11%, 15%, 13%, 16% and 18%, respectively, of total compensation (as shown in column (j) above) for 2008, (2) annual incentive compensation (as reflected in column (g) above) represented approximately 24%, 25%, 21%, 23% and 23%, respectively, of total compensation in 2008, and (3) salary and annual incentive compensation together represented approximately 35%, 39%, 34%, 38% and 41%, respectively, of total compensation in 2008.

For Messrs. Klappa, Leverett, Kuester and Fleming, and Ms. Rappé, (1) salary (as reflected in column (c) above) represented approximately 9%, 17%, 10%, 22% and 18%, respectively, of total compensation (as shown in column (j) above) for 2007, (2) annual incentive compensation (as reflected in column (g) above) represented approximately 19%, 28%, 17%, 32% and 22%, respectively, of total compensation in 2007, and (3) salary and annual incentive compensation together represented approximately 28%, 46%, 27%, 54% and 40%, respectively, of total compensation in 2007.

For Messrs. Klappa, Leverett, Kuester and Fleming, (1) salary (as reflected in column (c) above) represented approximately 13%, 19%, 16% and 21%, respectively, of total compensation (as shown in column (j) above) for 2006, (2) annual incentive compensation (as reflected in column (g) above) represented approximately 26%, 32%, 26% and 31%, respectively, of total compensation in 2006, and (3) salary and annual incentive compensation together represented approximately 39%, 51%, 42% and 52%, respectively, of total compensation in 2006.

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Grants of Plan-Based Awards for Fiscal Year 2008

The following table shows additional data regarding incentive plan awards to the named executive officers in 2008.

(a)	(b)		(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)		(l)
			Estimated Possible Payouts Under Non-Equity Incentive Plan Awards (2)			Estimated Future Payouts Under Equity Incentive Plan Awards (3)			All Other Stock Awards: Number of Shares of Stock or Units	All Other Option Awards (4)			Grant Date Fair Value of Stock and Option Awards (7)
Name	Grant Date	Action Date (1)	Threshold ($)	Target ($)	Maximum ($)	Threshold (#)	Target (#)	Maximum (#)	(#)	Number of Securities Underlying Options (#)	Exercise or Base Price (5) ($/Sh)	Closing Market Price (6) ($/Sh)	($)
Gale E. Klappa	1/17/08		564,504	1,129,008	2,370,917								
	1/02/08	12/6/07				7,500	30,000	52,500					1,434,000
	1/02/08	12/6/07								300,000	48.035	47.80	3,144,000
Allen L. Leverett	1/17/08		243,072	486,144	1,020,902								
	1/02/08	12/6/07				3,963	15,850	27,738					757,630
	1/02/08	12/6/07								164,250	48.035	47.80	1,721,340
Frederick D. Kuester	1/17/08		262,800	525,600	1,103,760								
	1/02/08	12/6/07				3,963	15,850	27,738					757,630
	1/02/08	12/6/07								164,250	48.035	47.80	1,721,340
James C. Fleming	1/17/08		154,350	308,700	648,270								
	1/02/08	12/6/07				1,525	6,100	10,675					291,580
	1/02/08	12/6/07								61,500	48.035	47.80	509,835
Kristine A. Rappé	1/17/08		118,113	236,225	496,073								
	1/02/08	12/6/07				1,213	4,850	8,488					231,830
	1/02/08	12/6/07								50,200	48.035	47.80	526,096

(1) On December 6, 2007, the Compensation Committee awarded the 2008 option and performance unit grants effective the first trading day of 2008 (January 2, 2008).

(2) Non-equity incentive plan awards consist of awards under Wisconsin Energy s Short-Term Performance Plan. The target bonus levels established for each of Messrs. Klappa, Leverett, Kuester and Fleming, and Ms. Rappé, for 2008 were 100%, 80%, 80%, 70% and 60% of base salary, respectively. Pursuant to the terms of their respective employment agreements, the target bonus levels for each of Messrs. Klappa, Leverett and Kuester, and Ms. Rappé, may not be adjusted downward except by an action of the Board or Compensation Committee which lowers the target bonus for the entire senior executive group. Based on certain financial and operational goals established by the Compensation Committee, actual payments to the named executive officers could have ranged from 0% of the target award to 210% of the target. Based on actual performance for 2008, each named executive officer earned 206.25% of the target award and these amounts are reported above in the Summary Compensation Table. For a more detailed description of the Short-Term Performance Plan, see the Compensation Discussion and Analysis above.

(3) Consists of performance units awarded under the Wisconsin Energy Corporation Performance Unit Plan. Upon vesting, the performance units will be settled in cash in an amount determined by multiplying the number of performance units which have become vested by the closing price of Wisconsin Energy s common stock on the last trading day of the performance period. The number of performance units that ultimately will vest is dependent upon Wisconsin Energy s total stockholder return over a three-year period ending December 31, 2010 as compared to the total stockholder return of a Custom Peer Group consisting of 27 companies. These companies are: Allegheny Energy, Inc.; Alliant Energy Corporation; Ameren Corporation; American Electric Power Company, Inc.; Avista Corporation; Consolidated Edison, Inc.; DTE Energy Company; Duke Energy Corp.; FirstEnergy Corp.; Great Plains Energy; Integrys Energy Group, Inc.; NiSource Inc.; Northeast Utilities; Nstar; OGE Energy Corp.; Pinnacle West Capital Corporation; Pepco Holdings, Inc.; PG&E Corporation; Portland General; Progress Energy Inc.; SCANA Corporation; Sempra Energy; Sierra Pacific Resources (n/k/a NV Energy, Inc.); The Southern Company; Westar Energy, Inc.; Wisconsin Energy Corporation; and Xcel Energy Inc.

Total stockholder return is the calculation of total return (stock price appreciation plus reinvested dividends) based upon an initial investment of $100 and subsequent $100 investments at the end of each quarter during the three-year performance period. The regular vesting schedule for the performance units is as follows:

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Percentile Rank	Vesting Percent
< 25th Percentile	0%
25th Percentile	25%
Target (50th Percentile)	100%
75th Percentile	125%
90th Percentile	175%

If Wisconsin Energy s rank is between the benchmarks identified above, the vesting percentage will be determined by interpolating the appropriate vesting percentage. Except as discussed herein, unvested performance units are immediately forfeited upon cessation of employment with Wisconsin Energy prior to completion of the three-year performance period.

The performance units will vest immediately at the target 100% rate upon (1) the termination of the named executive officer s employment by reason of disability or death or (2) a change in control of Wisconsin Energy while employed by the Company. In addition, a prorated number of performance units (based upon the target 100% rate) will vest upon the termination of employment by reason of retirement prior to the end of the three-year performance period. Participants, including the named executive officers, will receive a cash dividend when Wisconsin Energy declares a dividend on its common stock in an amount equal to the number of performance units granted to the named executive officer at the target 100% rate multiplied by the amount of the dividend paid on a share of common stock. The performance units have no voting rights attached to them.

(4) Consists of non-qualified stock options to purchase shares of Wisconsin Energy common stock pursuant to the 1993 Omnibus Stock Incentive Plan. These options have exercise prices equal to the fair market value of Wisconsin Energy common stock on the date of grant. These options were granted for a term of ten years, subject to earlier termination in certain events related to termination of employment. The options fully vest and become exercisable three years from the date of grant. Notwithstanding the preceding sentence, the options become immediately exercisable upon the occurrence of a change in control or termination of employment by reason of retirement, disability or death. The exercise price may be paid by delivery of already-owned shares. Tax withholding obligations related to exercise may be satisfied by withholding shares otherwise deliverable upon exercise, subject to certain conditions. Subject to the limitations of the 1993 Omnibus Stock Incentive Plan, the Compensation Committee has the power to amend the terms of any option (with the participant s consent).

(5) The exercise price of the option awards is equal to the fair market value of Wisconsin Energy s common stock on the date of grant, January 2, 2008. Fair market value is the average of the high and low prices of Wisconsin Energy common stock reported in the New York Stock Exchange Composite Transaction Report on the grant date.

(6) Reflects the closing market price of Wisconsin Energy common stock reported in the New York Stock Exchange Composite Transaction Report on the grant date.

(7) Grant date fair value of each award as determined in accordance with SFAS 123R, which includes the value of the right to receive dividends. The actual value received by the executives from these awards may range from $0 to greater than the reported amounts, depending upon Company performance and the executive s number of additional years of service with the Company.

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Outstanding Equity Awards at Fiscal Year-End 2008

The following table reflects the number and value of exercisable and unexercisable options as well as the number and value of other stock awards held by the named executive officers at fiscal year-end 2008.

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
	Option Awards					Stock Awards			
Name	Number of Securities Underlying Unexercised Options: Exercisable [1] (#)	Number of Securities Underlying Unexercised Options: Unexercisable [2] (#)	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#)	Option Exercise Price ($)	Option Expiration Date	Number of Shares or Units of Stock that Have Not Vested (#)	Market Value of Shares or Units of Stock that Have Not Vested [3] ($)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights that Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights that Have Not Vested [3] ($)
Gale E. Klappa	250,000			25.310	4/14/13				
	200,000			33.435	1/02/14				
	280,000			34.200	1/18/15				
		252,000		39.475	1/03/16				
		271,000		47.755	1/03/17				
		300,000		48.035	1/02/18				
						22,236 (4)	933,467		
								47,250 (9)	1,983,555 (9)
								52,500 (10)	2,203,950 (10)
Allen L. Leverett	200,000			29.130	7/01/13				
	150,000			33.435	1/02/14				
	100,000			34.200	1/18/15				
		95,000		39.475	1/03/16				
		129,000		47.755	1/03/17				
		164,250		48.035	1/02/18				
						4,346 (5)	182,445		
								22,313 (9)	936,700 (9)
								27,738 (10)	1,164,441 (10)
Frederick D. Kuester	200,000			31.070	10/13/13				
	150,000			33.435	1/02/14				
	100,000			34.200	1/18/15				
		95,000		39.475	1/03/16				
		129,000		47.755	1/03/17				
		164,250		48.035	1/02/18				
						13,335(6)	559,803		
								22,313 (9)	936,700 (9)
								27,738 (10)	1,164,441 (10)
James C. Fleming		75,000		39.475	1/03/16				
		61,500		47.755	1/03/17				
		61,500		48.035	1/02/18				
						1,596 (7)	67,000		
								10,675 (9)	448,137 (9)
								10,675 (10)	448,137 (10)
Kristine A. Rappé	10,000			27.313	6/02/09				
	20,925			33.435	1/02/14				
	65,000			34.200	1/18/15				

	58,000	39.475	1/03/16				
	48,500	47.755	1/03/17				
	50,200	48.035	1/02/18				
				4,150 (8)	174,217		
						8,400 (9)	352,632 (9)
						8,488 (10)	356,326 (10)

(1) All options reported in this column are fully vested and exercisable.

(2) All options reported in this column with an exercise price of $39.475 and an expiration date of January 3, 2016, fully vest and become exercisable on January 3, 2009. All options reported in this column with an exercise price of $47.755 and an expiration

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date of January 3, 2017, fully vest and become exercisable on January 3, 2010. All options reported in this column with an exercise price of $48.035 and an expiration date of January 2, 2018, fully vest and become exercisable on January 2, 2011.

(3) Based on the closing price of Wisconsin Energy common stock reported in the New York Stock Exchange Composite Transaction Report on December 31, 2008, the last trading day of the year.

(4) Effective April 14, 2003, Mr. Klappa was granted a restricted stock award of 39,510 shares, which vest at the rate of 10% for each year of service until 100% vesting occurs on April 14, 2013. Earlier vesting may occur due to (1) a termination of employment by (a) death, (b) disability, (c) a change in control of the Company, (d) Mr. Klappa for good reason, or (e) the Company without cause, or (2) action by the Compensation Committee. The number of shares reported includes shares acquired pursuant to the reinvestment of dividends on the restricted stock.

(5) Effective July 1, 2003, Mr. Leverett was granted a restricted stock award of 28,850 shares. Two-thirds of the shares vested on July 1, 2005 and the remaining one-third vest at the rate of 20% for each year of service after that date until 100% vesting occurs on July 1, 2010. Earlier vesting may occur due to (1) a termination of employment by (a) death, (b) disability, (c) a change in control of the Company, (d) Mr. Leverett for good reason, or (e) the Company without cause, or (2) action by the Compensation Committee. The number of shares reported includes shares acquired pursuant to the reinvestment of dividends on the restricted stock.

(6) Effective October 13, 2003, Mr. Kuester was granted a restricted stock award of 24,140 shares, which vest at the rate of 10% for each year of service until 100% vesting occurs on October 13, 2013. Earlier vesting may occur due to (1) a termination of employment by (a) death, (b) disability, (c) a change in control of the Company, (d) Mr. Kuester for good reason, or (e) the Company without cause, or (2) action by the Compensation Committee. The number of shares reported includes shares acquired pursuant to the reinvestment of dividends on the restricted stock.

(7) Effective January 6, 2006, Mr. Fleming was granted a restricted stock award of 2,500 shares, which vest at the rate of 20% for each year of service until 100% vesting occurs on January 6, 2011. Earlier vesting may occur due to termination of employment by death, disability or a change in control of the Company or by action of the Compensation Committee. The number of shares reported includes shares acquired pursuant to the reinvestment of dividends on the restricted stock.

(8) Effective each of June 2, 1999, October 21, 2000 and February 7, 2001, Ms. Rappé was granted shares of restricted stock that vest in full ten years from the respective grant date, subject to a performance accelerator. The performance accelerator is triggered by achieving certain cumulative earnings per share targets measured from the respective grant date. Ten percent annually is available for accelerated vesting and the stock is subject to cumulative vesting. Earlier vesting may occur due to termination of employment by death, disability or a change in control of the Company or by action of the Compensation Committee. In addition, the stock vests upon retirement at or after attainment of age 60. The number of shares reported includes shares acquired pursuant to the reinvestment of dividends on the restricted stock.

(9) The number of performance units reported vest at the end of the three-year performance period ending December 31, 2009. The number of performance units reported and their corresponding value are based upon a payout at the maximum amount.

(10) The number of performance units reported vest at the end of the three-year performance period ending December 31, 2010. The number of performance units reported and their corresponding value are based upon a payout at the maximum amount.

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Option Exercises and Stock Vested for Fiscal Year 2008

This table shows the number and value of (1) stock options that were exercised by the named executive officers, (2) restricted stock awards that vested and (3) performance units that vested in 2008.

(a)	(b)	(c)	(d)	(e)
	Option Awards		Stock Awards	
Name	Number of Shares Acquired on Exercise (#)	Value Realized on Exercise ($)	Number of Shares Acquired on Vesting (#)	Value Realized on Vesting ($)
Gale E. Klappa			4,576 (1)	207,476 (2)
			47,064 (3)	1,975,747 (4)
Allen L. Leverett			2,189 (1)	98,768 (2)
			20,352 (3)	854,377 (4)
Frederick D. Kuester			2,792 (1)	112,099 (2)
			20,352 (3)	854,377 (4)
James C. Fleming			528 (1)(5)	25,814 (2)(5)
			12,561 (3)	527,311 (4)
Kristine A. Rappé			3,124 (1)(5)	150,783 (2)(5)
			9,858 (3)	413,839 (4)

(1) Reflects the number of shares of restricted stock that vested in 2008.

(2) Restricted stock value realized is determined by multiplying the number of shares of restricted stock that vested by the fair market value of Wisconsin Energy common stock on the date of vesting. We compute fair market value as the average of the high and low prices of Wisconsin Energy common stock reported in the New York Stock Exchange Composite Transaction Report on the vesting date.

(3) Reflects the number of performance units that vested as of December 31, 2008, the end of the applicable three-year performance period. The performance units were settled in cash.

(4) Performance units value realized is determined by multiplying the number of performance units that vested by the closing market price of Wisconsin Energy common stock on December 31, 2008.

(5) Mr. Fleming and Ms. Rappé deferred $25,814 and $148,658, respectively, into the WEC Executive Deferred Compensation Plan. The number of phantom stock units received in the WEC Executive Deferred Compensation Plan equaled the number of shares of restricted stock deferred.

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Pension Benefits at Fiscal Year-End 2008

The following table sets forth information for each named executive officer regarding their pension benefits at fiscal year-end 2008 under WEC s four different retirement plans discussed below.

(a) Name	(b) Plan Name	(c) Number of Years Credited Service [(1)] (#)	(d) Present Value of Accumulated Benefit [(2)(3)] ($)	(e) Payments During Last Fiscal Year ($)
Gale E. Klappa	WEC Plan	5.67	93,234	
	SERP A	5.67	947,748	
	Individual Letter Agreement	31.33	10,721,933	
Allen L. Leverett	WEC Plan	5.50	75,466	
	SERP A	5.50	460,141	
	Individual Letter Agreement	20.00	626,689	
Frederick D. Kuester	WEC Plan	5.17	82,812	
	SERP A	5.17	421,226	
	Individual Letter Agreement	36.33	6,454,253	
James C. Fleming	WEC Plan	3.00	47,375	
	SERP A	3.00	123,448	
	Individual Letter Agreement	3.00	373,900	
Kristine A. Rappé	WEC Plan	26.33	534,461	
	SERP A	26.33	1,292,045	
	SERP B	[(4)]	392,754	
	Individual Letter Agreement			

(1) Years of service are computed as of December 31, 2008, the pension plan measurement date used for financial statement reporting purposes. Messrs. Klappa, Leverett and Kuester have been credited with 25.66, 14.5 and 31.16 years of service, respectively, pursuant to the terms of their Individual Letter Agreements (ILAs). The increase in the aggregate amount of each of Messrs. Klappa s, Leverett s and Kuester s accumulated benefit under all of Wisconsin Energy s retirement plans resulting from the additional years of credited service is the amount identified in connection with each respective ILA set forth in column (d).

(2) The key assumptions used in calculating the actuarial present values reflected in this column are:

First projected unreduced retirement age based on current service:

For Mr. Klappa, age 62.

For Messrs. Leverett and Fleming, and Ms. Rappé, age 65.

For Mr. Kuester, age 60.

Discount rate of 6.50%.

Cash balance interest crediting rate of 6.75%.

Form of payment:

WEC Plan: Lump sum.

SERP: Life annuity.

ILA: Life annuity, other than Mr. Fleming who we assume will receive a lump sum payment.

Mortality Table, for life annuity:

Messrs. Klappa, Leverett and Kuester - RP2000 with projection to 2010 - Male.

Mr. Fleming N/A.

Ms. Rappé - RP2000 with projection to 2010 - Female.

(3) Wisconsin Energy s pension benefit obligations to Messrs. Klappa, Leverett and Kuester will be partially offset by pension benefits Messrs. Klappa, Leverett and Kuester are entitled to receive from their former employers. The amounts reported for Messrs. Klappa, Leverett and Kuester represent only Wisconsin Energy s obligation of the aggregate actuarial present value of each of their accumulated benefit under all of the plans. The total aggregate actuarial present value of each of Messrs. Klappa s, Leverett s and Kuester s accumulated benefit under all of the plans is $14,599,114, $1,336,398 and $9,385,294, respectively, $2,836,200, $174,102 and $2,bsp;

Balance at December 31, 2001	12,896	129	91,649				(63,918)	27,860
Exercise of stock options			2					2
Common Stock issued for 401k/401m plan	26		137					137
Common Stock issued for sublicense agreement (Note 6)	50	1	204					205
Common Stock issued to consultants			17					17
Amortization of non-employee options			66					66
Warrants issued for services			247					247
Net loss							(17,502)	(17,502)
	12,972	130	92,322				(81,420)	11,032

Balance at December 31, 2002							
Common Stock issued for 401k/401m plan	32		223				223
Exercise of warrants	467	5	3,323				3,328
Exercise of stock options	85	1	955				956
Stock options issued			561				561
Private Placement, net of expenses	1,283	13	14,290				14,303
Common Stock issued for sublicense agreement (Note 6)	119	1	644				645
Common Stock issued for milestone payment	50	1	281				282
Debt Conversion	1,755	17	9,983				10,000
Common Stock issued in lieu of cash / interest	9		142				142
Public Offering, net of expenses	2,500	25	58,576				58,601
Deemed discount on convertible debentures			6,470				6,470
Warrants issued for services			1,398				1,398
Amortization of non-employee options			128				128
Purchase of treasury stock				(59)	(346)		(346)
Net loss						(25,671)	(25,671)
Balance at December 31, 2003	19,272	193	189,296	(59)	(346)	(107,091)	82,052
Common Stock issued for 401k/401m plan	17		147				147
Exercise of warrants	6		11				11
Exercise of stock options	4		16				16
Common Stock issued for In-Process R&D (Note 6)	48		629				629
Amortization of non-employee options			136				136
Net loss						(24,757)	(24,757)

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	Preferred stock at par value		Common stock at par value		Capital in excess of	Cost of Repurchased Common Stock		Deferred	Deficit accumulated during development	
	Shares	Amount	Shares	Amount	par value	Shares	Amount	compensation	stage	Total
						(In thousands)				
Balance at December 31, 2004			19,347	$ 193	$ 190,235	(59)	$ (346)		$ (131,848)	$ 58,234
Common Stock issued for 401k/401m plan			25		151					151
Exercise of warrants			42	1	260					261
Exercise of stock options			35	1	123					124
Public Offering, net of expenses (Note 7)			1,333	13	9,502					9,515
Amortization of non-employee options					30					30
Net loss									(29,441)	(29,441)
Balance at December 31, 2005			20,782	$ 208	200,301	(59)	$ (346)		$ (161,289)	$ 38,874

The accompanying notes are an integral part of these financial statements.

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Hollis-Eden Pharmaceuticals, Inc.

(A Development Stage Company)

Statements of Cash Flows

	2005	2004	2003	Period from Inception (Aug. 15, 1994) to December 31, 2005
		(In thousands)		
Cash flows from operating activities:				
Net loss	$ (29,441)	$ (24,757)	$ (25,671)	$ (161,289)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation	303	218	118	1,096
Disposal of assets		33	2	63
Amortization of deemed discount on convertible debentures			6,470	6,470
Amortization of deferred issuance cost			1,157	1,157
Common stock issued for 401k/401m plan	151	147	223	817
Common stock issued as consideration for amendments to the license agreements				33
Common stock issued as consideration for termination of a finance agreement				34
Common stock and options issued as consideration for license fees, milestone payment, interest and services	30	136	552	2,859
Expense related to warrants issued as consideration to consultants			1,518	4,113
Expense related to warrants issued to a director for successful closure of merger				570
Expense related to stock options issued			561	5,718
Expense related to common stock issued for the purchase of technology				1,848
Common stock issued as consideration for In-Process R&D		629		2,629
Deferred compensation expense related to options issued				1,210
Changes in assets and liabilities:				
Prepaid expenses	(28)	(42)	(11)	(204)
Deposits	(8)	(10)	(8)	(113)
Other receivable	1	(9)	13	(8)
Other Receivable from related party	(11)	18	3	(11)
Accounts payable, accrued expenses, and deferred revenue	2,700	1,679	1,024	8,352
Net cash used in operating activities	(26,303)	(21,958)	(14,049)	(124,656)
Cash flows provided by investing activities:				
Purchase of property and equipment	(458)	(930)	(4)	(2,275)
Payback of loan by a company officer			253	
Net cash provided by (used in) investing activities	(458)	(930)	249	(2,275)
Cash flows from financing activities:				
Contributions from stockholder				104
Net proceeds from sale of preferred stock				4,000
Net proceeds from sale of common stock	9,515		72,413	134,757
Net proceeds from issuance of convertible debentures and warrants			9,214	9,214
Purchase of treasury stock			(346)	(346)
Proceeds from issuance of debt				371
Net proceeds from recapitalization				6,271

Net proceeds from warrants/options exercised	385	27	4,284	17,690
Net cash provided by financing activities	9,900	27	85,565	172,061
Net increase (decrease) in cash and equivalents	(16,861)	(22,861)	71,765	45,130
Cash and equivalents at beginning of period	61,991	84,852	13,087	
Cash and equivalents at end of period	$ 45,130	$ 61,991	$ 84,852	$ 45,130
Supplemental disclosure of cash flow information:				
Interest paid	$	$	$ 338	$ 388
Conversion of debt to equity			10,000	10,371
Warrants issued to consultants in lieu of cash, no vesting				559
Warrants issued in lieu of cash, commissions on private placement				733
Warrants issued in connection with convertible debentures			371	371

The accompanying notes are an integral part of these financial statements.

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Hollis-Eden Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Financial Statements

1. The Company

Hollis-Eden Pharmaceuticals, Inc. (Hollis-Eden or the Company), a development stage pharmaceutical company, is engaged in the discovery, development and commercialization of products for the treatment of diseases and disorders in which the body is unable to mount an appropriate immune response. From inception (August 15, 1994) through March 1997, the Company s efforts were directed toward organizing, licensing technology and preparing for offerings of shares of its common stock. Since 1997, the Company has been expanding its intellectual property, developing its lead drug candidates, performing preclinical tests and has entered into multiple clinical studies. The Company s initial technology development efforts are focused on a series of potent hormones and hormone analogs that the company believes are key components of the body s natural regulatory system. The Company believes these immune regulating hormones can be used to reestablish host immunity in situations of dysregulation. Beginning in the second quarter of 2004, the Company has been generating a small amount of revenue. This revenue resulted from providing research and development services under the Company s Study Funding Agreement with Cystic Fibrosis Foundation Therapeutics, Inc. To date, the Company has not developed commercial products or generated any product sales for the period since inception (August 15, 1994 through December 31, 2005).

2. Summary of Accounting Policies

Cash Equivalents

The Company considers any liquid investments with a maturity of three months or less when purchased to be cash equivalents. At December 31, 2005 the Company s cash equivalents are approximately $45.1 million and are deposited primarily in a money market mutual fund with a large financial institution.

Property and Equipment

Property and equipment is stated at cost and depreciated over the estimated useful lives (five and seven years) or the remaining lease term of the assets using the straight-line method.

Revenue Recognition

In December 2003, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 104 Revenue Recognition (SAB 104), which updates and summarizes the Commission s views on the application of generally accepted accounting principles to revenue recognition in financial statements. The Company believes that its revenue recognition policies conform to the requirements of SAB 104.

Contract revenue is recognized as the services are performed on a cost reimbursement basis. Revenue associated with development milestones, if any, is recognized based upon the achievement of the milestones, as defined in the respective agreements. Overall, revenue is considered to be realized or realizable and earned when there is persuasive evidence of a revenue arrangement in the form of a contract or purchase order, the services have been performed, the price is fixed or determinable and collectability is reasonable assured.

Research and Development

All research and development costs are expensed as incurred. The value of acquired in-process research and development is charged to expense on the date of acquisition. Research and development expenses include, but are not limited to, acquired in-process technology deemed to have no alternative future use, license fees related to license agreements, preclinical and clinical trial studies, payroll and personnel expense, and lab supplies, consulting and research-related overhead. Research and development expenses paid in the form of cash and Company stock to related parties aggregated $11.5 million for the period from inception (August 15, 1994) to

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Hollis-Eden Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Financial Statements (Continued)

December 31, 2003 (see Note 6, Colthurst, Edenland and Mr. Prendergest and Aeson Therapeutics). No such related party expenses were incurred in 2004 or 2005.

Accounting for Stock-Based Compensation

The Company has elected to follow Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees*, and related interpretations in accounting for its employee stock options rather than the alternative fair value accounting provided for under SFAS No. 123, *Accounting and Disclosure for Stock-Based Compensation.* The Company has also adopted the pro forma disclosure requirements of SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123.* In accordance with APB 25, compensation cost relating to stock options granted by the Company is measured as the excess, if any, of the market price of the Company s stock at the date of grant over the exercise price of the stock options. This expense is recognized over the vesting period of the stock options.

As required by SFAS No. 148 and SFAS No. 123, the Company provides pro forma net (loss) and pro forma net (loss) per common share disclosures for stock-based awards made during the periods presented as if the fair-value-based method defined in SFAS No. 123 had been applied.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options vesting period (See Note 9). The Company s net loss would have been reported as follows (in thousands, except per share amounts):

	Year ended December 31,		
	2005	**2004**	**2003**
Net loss As reported	$ (29,441)	$ (24,757)	$ (25,671)
Add: Stock-based employee compensation expense included in reported net loss			122
Deduct: Total stock-based employee compensation expense determined under fair-value-based method for all awards	(4,910)	(5,203)	(4,865)
Net loss Pro forma	$ (34,351)	$ (29,960)	$ (30,414)
Basic and diluted net loss per share As reported	$ (1.46)	$ (1.28)	$ (1.67)
Basic and diluted net loss per share Pro forma	$ (1.71)	$ (1.55)	$ (1.98)

Income Taxes

The Company provides for income taxes under the principles of SFAS 109 which requires that provision be made for taxes currently due and for the expected future tax effects of temporary differences between book and tax bases of assets and liabilities.

Financial Instruments

The Company s financial instruments consist primarily of cash, other receivables and accounts payable. These financial instruments are stated at their respective carrying values, which approximate their fair values, due to their short term nature.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported

Hollis-Eden Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Financial Statements (Continued)

amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could materially differ from those estimates.

Concentrations of Risk

Financial instruments, which potentially expose the Company to concentrations of credit risk, consist primarily of cash and cash equivalents. The Company places its cash with high quality financial institutions. Cash balances are generally substantially in excess of the amounts insured by the Federal Deposit Insurance Corporation.

Net Loss per Share

Basic net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed in a manner consistent with basic net loss per share after giving effect to potentially dilutive securities. Potential common shares of 8,253,374, 7,813,643, and 7,097,978 related to the Company s outstanding stock option and warrants were excluded from the computation of diluted net loss per share for the years ended December 31, 2005, 2004 and 2003 because their effect on net loss per share is anti-dilutive.

Recent Accounting Pronouncements

In December 2004, SFAS No. 123(R), Share-Based Payment, which addresses the accounting for employee stock options, was issued. SFAS 123(R) revises the disclosure provisions of SFAS 123 and supersedes APB Opinion No. 25. SFAS 123(R) requires that the cost of all employee stock options, as well as other equity-based compensation arrangements, be reflected in the financial statements based on the estimated fair value of the awards. This statement is effective for all public entities that file as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. The Company expects the adoption of SFAS 123R to increase our reported net loss and earnings per share. The Company has not elected to early implement SFAS 123(R) for the year ended December 31, 2005.

In December 2004, the FASB issued SFAS 153, Exchanges of Nonmonetary Assets, an Amendment of APB Opinion No. 29 (SFAS 153). The guidance in APB Opinion No. 29, Accounting for Nonmonetary Transactions, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in APB Opinion No. 29, however, included certain exceptions to that principle. SFAS 153 amends APB Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for nonmonetary asset exchanges in fiscal periods beginning after June 15, 2005. The adoption of SFAS 153 has not had a material impact on our results of operations or financial position.

3. Recapitalization

During March 1997, Hollis-Eden Inc. was merged (the Merger) with and into the Company (then known as Initial Acquisition Corp. (IAC)). Upon consummation of the Merger, Hollis-Eden Inc. ceased to exist, and IAC changed its name to Hollis-Eden Pharmaceuticals, Inc. IAC (now called Hollis-Eden Pharmaceuticals, Inc.) remains the continuing legal entity and registrant for Securities and Exchange Commission reporting purposes.

Hollis-Eden Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Financial Statements (Continued)

The Merger was accounted for as a recapitalization of Hollis-Eden Inc. by an exchange of Common Stock of Hollis-Eden Inc., for the net assets of IAC, consisting primarily of $6.5 million in cash and other receivables.

Under the terms of the merger agreement, each share of Hollis-Eden Inc. Common Stock outstanding converted into one share of Common Stock of Hollis-Eden Pharmaceuticals, Inc. Common Stock (Company Common Stock), and all warrants and options to purchase Hollis-Eden Inc. Common Stock outstanding converted into the right to receive the same number of shares of Company Common Stock.

Upon the consummation of the Merger, pursuant to an agreement, the Company issued warrants to purchase an aggregate of 50,000 shares of Company Common Stock at an exercise price of $0.10 per share to a director and former officer. Additional paid-in capital was increased by $570,000 with an offsetting $570,000 charge recorded to operations during the three months ended March 31, 1997.

4. Receivable from Related Party

On April 23, 2001, the Company entered into a promissory note with a stockholder/officer in the amount of $16,875. Interest was at 4.5% per annum. The promissory note was paid in full prior to the due date of April 23, 2004.

On May 22, 1998, the Company entered into a promissory note with a stockholder/officer in the amount of $200,000. Interest was at 5.5% per annum. The note was repaid in full in May 2003.

On March 21, 2005, the Company entered into a promissory note with an employee with a maximum loan amount of $20,000. Interest was at 6% per annum. The first installment of $10,000 was made on the commencement date. A second installment of $10,000 was made on April 20, 2005. The loan is being repaid on a bi-monthly basis.

5. Income Taxes

The Company has available a net operating loss carryforward of approximately $131 million at December 31, 2005 which may be carried forward as an offset to taxable income, if any, in future years through its expiration in 2012 to 2025. The Company has a net deferred tax asset of approximately $52 million at December 31, 2005 comprised of capitalized start-up costs, research and development credits, and the net operating loss carryforward. The net deferred tax asset has been fully reserved due to the uncertainty of the Company being able to generate taxable income under the more likely than not criteria of SFAS 109. If certain substantial changes in the Company s ownership should occur, there would potentially be an annual limitation on the amount of the carryforwards, which could be utilized in a tax year. The Company has not performed a section 382 change in control test to date. Until this test is performed, the Company cannot be certain of the use of the loss carryforwards.

6. Related Party Licenses and other Agreements and Contingencies

Colthurst, Edenland and Mr. Prendergast

During 1994, the Company entered into two license agreements and one research, development and option agreement as discussed in the following paragraphs.

Pursuant to a license agreement dated May 18, 1994 (Colthurst License Agreement) with related parties, Patrick T. Prendergast, a significant stockholder at the time, and with Colthurst Limited, a company controlled by

Hollis-Eden Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Financial Statements (Continued)

Mr. Prendergast, the Company acquired the exclusive worldwide rights to Mr. Prendergast s patent rights, know-how and background technology relating to the treatment of human/animal immunodeficiency. The agreement was amended on August 11, 1995 to change the license fee payment terms as discussed below in paragraph four of this Note. Per the license agreement, the Company agreed to pay royalties on product revenues.

On August 25, 1994, the Company entered into a license agreement (Edenland License Agreement) with a related party, Edenland Inc., a company controlled by Mr. Prendergast, for the exclusive worldwide rights to Mr. Prendergast s patent rights, know-how and background technology related to the substance tradenamed HE317 and to any other pharmaceutical product that became subject to the license agreement under the research, development and option agreement discussed below. The agreement was amended on August 11, 1995 to change the license fee payment terms as discussed in the following paragraph. Per the Edenland License Agreement, the Company agreed to pay royalties on product revenues.

Effective August 11, 1995, Edenland, Inc., Colthurst Limited and the Company entered into amendments concerning the license fee payment terms to the two agreements described above. Under this amendment, the Company agreed to pay a license fee by April 28, 1996 plus additional license fees within 24 months of April 1996. The balances of these fees were paid in full by May 1997. As consideration for entering into certain amendments, the Company issued 75,472 shares of the Company s common stock to Edenland, Inc. and Colthurst Limited.

Per the amended Colthurst License Agreement, a renewal annual license fee was payable commencing May 1998. The Company paid this fee in 1998 by issuing shares of its common stock and, in 1999, paid in cash.

In August 1994, the Company entered into a Research, Development and Option Agreement, with Edenland, Inc. and Mr. Prendergast. The agreement provided for the development of HE317 to a certain stage of development and granted the Company the right of first option on new products developed by Edenland, Inc. The agreement committed the Company to pay for certain development costs up to the amount of $3.0 million with certain contingencies for funding. In October 1996, the Company and Edenland, Inc. entered into an amendment, which accelerated the date that the $3.0 million payment for HE317 or other product development costs was to be made. The Company paid $2.7 million during 1997 and the remaining $300,000 in April 1998.

During November 1999, the Company filed two separate requests for arbitration with Mr. Prendergast, Colthurst and Edenland. The first arbitration sought clarification of certain operational issues with respect to roles and responsibilities set forth in the license agreement covering IMMUNITIN. The second arbitration sought to rescind both of the agreements with Edenland covering future potential drug candidates other than IMMUNITIN.

On January 20, 2000, Hollis-Eden reached a settlement on its pending arbitrations with Mr. Prendergast, Colthurst and Edenland. The Settlement and Mutual Release Agreement completely disposed of all of the matters that were at issue in the pending arbitrations. In addition, the parties entered into two new technology agreements, the Technology Assignment Agreement and the Sponsored Research and License Agreement.

The Technology Assignment Agreement (Assignment Agreement) replaced the Colthurst License Agreement. Pursuant to the Assignment Agreement, Mr. Prendergast and Colthurst assigned to Hollis-Eden ownership of all patents, patent applications and current or future improvements of the technology under the Colthurst License Agreement, including IMMUNITIN, Hollis-Eden s lead clinical compound at the time. The annual license fee of $500,000 and the royalty obligations under the Colthurst License Agreement were eliminated. In consideration for the foregoing, Hollis-Eden agreed to issue to Colthurst 660,000 shares of Common Stock and a warrant to purchase an aggregate of 400,000 shares of Common Stock at $25 per share.

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Notes to Financial Statements (Continued)

Only 132,000 of such shares of Common Stock were issued in 2000, with the remaining 528,000 shares to be issued over the next four years conditioned on continued compliance with the agreement and, in particular, satisfaction of the Conditions (as defined below). In addition, all of the shares under the warrant vest over four years conditioned on continued compliance with the agreement and, in particular, satisfaction of the Conditions (as defined below). The Sponsored Research and License Agreement replaced the Edenland License Agreement and the Research, Development and Option Agreement. Pursuant to the Sponsored Research and License Agreement, Edenland exclusively licensed to Hollis-Eden a number of compounds, together with all related patents and patent applications, and Hollis-Eden funded additional preclinical research projects conducted by Edenland. Hollis-Eden would also have exclusive license rights to all results of such research and would have royalty obligations to Edenland on sales of new products, if any, resulting from such research. None of the compounds licensed under the Sponsored Research and License Agreement have been developed by Hollis-Eden and, as described below, this agreement is now terminated.

As stated above, the issuance of the additional shares of Common Stock and the vesting of the warrant was dependent upon the satisfaction of certain conditions (the Conditions), including (i) support of Hollis-Eden s actions by Mr. Prendergast and Colthurst, by voting their shares of Hollis-Eden stock in favor of management and (ii) Mr. Prendergast and his affiliated companies not conducting research and development activities relating to the transferred technology. In accordance with Emerging Issues Task Force No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services, these future events could not be determined at the date of the agreements (January 2000). Accordingly, the shares and warrants are accounted for as they vest or are issued. During 2000, the Company recorded a research and development charge for $1.9 million representing the fair value of the 132,000 shares issued under the Assignment Agreement.

Because all of the Conditions were not satisfied, Hollis-Eden did not issue any additional shares to Colthurst and believed it had no obligation to issue any additional shares and that the warrant would not vest as to any shares of Common Stock.

After arbitration proceedings during 2004 and 2005, pursuant to which Colthurst sought more than $25 million in damages for the non-issuance of the 528,000 shares of common stock and the warrant to purchase up to 400,000 shares of common stock, in February 2006 the parties agreed to a settlement and release of all issues in dispute between the parties. Under the agreement, (1) the Company agreed to make a payment of $3 million in cash and (2) the parties agreed to terminate the Sponsored Research and License Agreement between the Company and Edenland Inc. The $3.0 million was accrued as an expense as of December 31, 2005. Under the settlement agreement, the Colthurst parties remain prohibited from conducting any further research, development or commercialization activities of any kind relating in any way to the technology (including IMMUNITIN) that was assigned to the Company under the Assignment Agreement.

Aeson Therapeutics

In October 2000, the Company acquired a 21% equity stake in Aeson Therapeutics Inc. (Aeson) and an exclusive worldwide sublicense to three issued patents in the area of adrenal steroids in exchange for $2.0 million in cash and 208,672 shares of Common Stock valued at $2 million. The cash and shares were expensed as in-process R&D during the fourth quarter of 2000. As part of the transaction, Aeson and its shareholders granted the Company an exclusive option to acquire the remainder of Aeson at a predetermined price.

In March 2002, the Company amended certain of its agreements with Aeson. Under the amendments, the Company paid Aeson $1.2 million, which extended the initial date by which the Company could exercise its

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Hollis-Eden Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Financial Statements (Continued)

option to acquire the remainder of Aeson to September 30, 2002. Hollis-Eden also received additional equity securities as a result of its $1.2 million payment and now has approximately a 25% equity stake in Aeson. The $1.2 million payment was expensed as in-process R&D.

Hollis-Eden elected not to exercise the option to acquire the remainder of Aeson by September 30, 2002. Accordingly, the option to acquire Aeson has now expired. The Company continues to hold a 25% equity interest in Aeson which is accounted for under the equity method.

Pharmadigm

In August 2002, we entered into a Sublicense Agreement with Pharmadigm, Inc. Under the agreement, we obtained exclusive worldwide rights to certain intellectual property of Pharmadigm and the University of Utah and we agreed to make aggregate payments of $0.9 million in cash or in shares of our common stock, at our option, over the next year. This cost was expensed in the third quarter of 2002. We elected to make such payments in equity and have issued a total of 168,921 shares of our common stock in complete satisfaction of this requirement (of which 118,921 were issued the quarter ended March 31, 2003). We may also make substantial additional milestone and royalty payments in cash to Pharmadigm if we meet specified development and commercialization milestones for products covered by the patents. To date, no such milestones have been met to date. The principal patents licensed under the agreement, originally licensed to Pharmadigm from the University of Utah, relate to inventions by Dr. Raymond Daynes and Dr. Barbara A. Areneo. Dr. Daynes served as a scientific consultant to Hollis-Eden from 1999 to mid-2003.

Congressional Pharmaceutical

In February 2004, the Company acquired Congressional Pharmaceutical Corporation (CPC) and replaced CPC as the exclusive licensee to certain intellectual property rights held by the University of Chicago. These intellectual property rights consist of a series of patents and patent applications that relate to discoveries made by David J. Grdina, Ph.D., Professor of Radiation and Cellular Oncology at the University of Chicago. The patented technology covers a series of compounds that have the potential to protect against DNA mutations that can occur as a result of radiation injury or chemotherapy. In the acquisition the Company issued approximately 50,000 shares of common stock to the former stockholders of CPC valued at approximately $650,000, in accordance with Emerging Issues Task Force No. 99-12. In addition, if the Company achieves certain development milestones, it will be required to issue additional shares of our common stock to the former stockholders of CPC. In the event all of the milestones are achieved, the total number of additional shares that the Company would be required to issue to the former stockholders of CPC is 275,000, more than half of which would be issued only upon FDA approval of CPC s product. No such milestone has been met to date. Furthermore, upon regulatory approval and commercialization of products covered by the licensed intellectual property, the Company may be required to pay royalties to the former stockholders of CPC and the University of Chicago. Following the acquisition, Dr. Grdina agreed to an exclusive consulting arrangement with the Company in the fields of hematopoiesis and radiation and chemotherapy exposure.

AFRRI Collaboration

The Company is performing work on multiple task orders that were issued under a collaboration with the Armed Forces Radiobiology Research Institute (AFRRI). Under these task orders, the Company is conducting radiation studies with a subcontractor. The task orders commit AFRRI to reimburse the Company for $2.0 million in subcontractor fees. The reimbursement amounts from AFRRI will be recorded in the same timeline as the subcontractor fees, resulting in no impact on the statement of operations. The company has received

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Hollis-Eden Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Financial Statements (Continued)

reimbursements by AFRRI in excess of payments to subcontractors in the amount of $585,000 as of December 31, 2005. This amount was recorded as a liability.

Study Funding Agreement

The Company has a Study Funding Agreement with Cystic Fibrosis Foundation Therapeutics, Inc. (CFFT). The agreement commits CFFT to provide a total of $1.7 million to be paid in seven tranches based on the Company s completion of certain agreed-upon events. The agreement also contains a provision indicating that upon termination of this agreement by either party, CFFT shall pay the Company for all work performed through the date of termination, plus reasonable costs of bringing the study to an orderly close.

In return for this funding, the Company has agreed to pay CFFT a minimum royalty over a specified period following regulatory approval in the United States of America. Additional compensation is due to CFFT if net sales of this compound exceed a specified amount over a period of time.

Revenue is recognized under this agreement on a percentage of completion method for each distinct agreed-upon event, and the Company has a liability of $193,531 recorded as deferred revenue as of December 31, 2005.

7. Common Stock

Reverse Stock Splits

During February 1995, there was a 3-for-5 reverse stock split of the Company s common stock and in March 1996, a 1-for-2.65 reverse stock split of the Company s common stock. Both reverse stock splits have been retroactively reflected for all periods presented.

Common Stock Financings

In January 1996, the Company completed a $367,522 round of debt financing with a group of private investors. These notes, with an 8% interest rate, were due on or before the earlier of (i) January 21, 1997 or (ii) the closing of a private or public offering of securities. During April 1996, the debt financing, plus accrued interest, was converted into 164,962 shares of common stock at a price of $2.25 per share. In April 1996, the Company privately issued 580,005 shares of the Company s common stock at an offering price of $2.25 per share. Total proceeds from this offering aggregated $1,234,499.

During May 1998, the Company completed a private financing totaling $20.6 million in gross proceeds. The Company issued 1,329,201 shares of common stock, (of which 192,061 shares were subject to adjustment based on future average stock price (Adjustable Common Stock)), 4,000 shares of 5% Series A Convertible Preferred Stock and warrants to purchase 1,437,475 shares of common stock in the financing. The warrants entitled the holders to purchase up to a total of 1,437,475 shares of common stock at a price of $17.00 per share.

The Convertible Preferred Stock had an initial conversion price of $20.30 for the first seven months, after which it could be adjusted, either up or down, based on the future stock prices of the Company s common stock. The Convertible Preferred Stock was converted to common stock in January 1999 (See Note 8).

In January 1999, the Company completed two private placements of an aggregate of 1,367,868 shares of common stock at prices ranging from $18.00 to $18.50 per share. In connection with the private placements, the Company issued warrants to purchase an aggregate of 90,000 shares of the Company s common stock, with an exercise price of $18.25 per share, as a finder s fee. The Company raised approximately $25.0 million in gross proceeds.

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Hollis-Eden Pharmaceuticals, Inc.

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Notes to Financial Statements (Continued)

During December 2001, the Company raised $11.5 million in gross proceeds from the sale of 1.28 million shares of newly issued common stock in a private placement at a price of $9.00 per share. The investors were a group of qualified institutional buyers and institutional accredited investors. The Company also issued warrants to purchase up to 128,000 shares of common stock having an exercise price of $12.00 per share to investors. As a finders fee, the Company issued to its placement agent two warrants for a total of 112,640 shares of common stock, one warrant with an exercise price of $9.00 and the other with an exercise price of $12.00.

On February 25, 2003, we completed a private placement in which we issued $10.0 million aggregate principal amount of three-year convertible debentures (debentures), bearing interest at 7.5% per year, and warrants to purchase up to 701,760 shares of common stock. The debentures were convertible into common stock at a price of $5.70 per share, which represented a discount from the price of our common stock on the commencement date. Also issued in connection with this private placement were warrants to purchase up to 350,880 shares of common stock which are exercisable at a price per share of $6.17, subject to adjustment, and warrants to purchase up to 350,880 shares of common stock which are exercisable at a price per share of $6.71, subject to adjustment. The warrants are exercisable until February 25, 2007.

In connection with the issuance of the debentures and warrants, we recorded approximately $3.5 million related to the beneficial conversion feature and approximately $3.0 million for the detachable warrants on the debentures. The total amount of the deemed discount on the debentures as a result of the warrant issuance and the beneficial conversion feature amounts to $6.5 million. The beneficial conversion feature and warrant value (deemed discount) were amortized over the term of the debentures and as conversion of the debentures occurred.

On June 20, 2003, convertible debentures with a face value of $0.5 million were converted into 87,720 shares of our common stock leaving a $9.5 million aggregate principle amount of convertible debentures outstanding. On August 11, 2003, the remaining aggregate principal amount of convertible debentures with a face value of $9.5 million were converted into 1,666,680 shares of our common stock with a value of $5.70 per share.

During June 2003, the Company completed a private placement of common stock and warrants, from which it received gross proceeds of $14.7 million. In October 2003 the Company completed a public offering of an aggregate of 2,500,000 shares of common stock at a price of $25.00 per share and received $62.5 million in gross proceeds from this offering.

On June 1, 2005 the Company raised approximately $10.0 million in gross proceeds from the sale of 1,333,333 shares of the Company s common stock at an exercise price of $6.17 per share. Additionally, the Company issued a four-year warrant to purchase up to an additional 266,667 shares of common stock at an exercise price of $10.00 per share. In connection with this transaction, the Company incurred approximately $0.5 million in direct costs and recorded net proceeds of approximately $9.5 million.

8. Preferred Stock

During May 1998, as part of a private placement, the Company issued 4,000 shares of Convertible Preferred Stock for proceeds of $4.0 million. The proceeds of the offering are included in the proceeds to the May 1998 financing described in Note 7, above.

During January 1999, the Company issued 346,127 shares of common stock in connection with the conversion of the Series A Convertible Preferred Stock and additional shares relating to the Adjustable Common Stock. The Adjustable Common Stock was issued during the private placement of May 1998 and was subject to

Hollis-Eden Pharmaceuticals, Inc.

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Notes to Financial Statements (Continued)

adjustment based on the future average stock price of the Company s common stock as described in Note 7. Upon conversion, all outstanding shares of Preferred stock and Adjustable Common stock were eliminated.

In November 1999, the Company adopted a Shareholders Rights Plan in which Preferred Stock purchase rights (Rights) were distributed as a dividend at the rate of one Right for each share of common stock held as of the close of business on November 29, 1999. Each right entitles stockholders to buy, upon certain events, one one-hundredth of a share of a new Series B junior participating preferred stock of the Company at an exercise price of $100.00. The Rights are designed to guard against partial tender offers and other abusive tactics that might be used in an attempt to gain control of the Company or to deprive stockholders of their interest in the long-term value of the Company. The Rights are exercisable only if a person or group acquires 15% or more of the Company s common stock or announces a tender offer of which the consummation would result in ownership by a person or group of 15% or more of the Company s common stock. The Rights are redeemable for one cent per Right at the option of the Board of Directors prior to this event occurring. The Rights expire on November 14, 2009.

9. Stock Options

1997 Stock Option Plan

The 1997 Stock Option Plan (the Plan) was approved by the Company s stockholders in 1997. Under the Plan, shares of common stock have been reserved for issuance to employees, officers, directors, and consultants of the Company and provides for the grant of incentive and nonstatutory stock options. The Board of Directors determines terms of the stock option agreements, including vesting requirements. The exercise price of incentive stock options must equal at least the fair market value on the date of grant. The options expire not later than ten years from the date of the grant and generally are exercisable ratably over a three-year or four-year period beginning one-year from the date of the grant.

2005 Equity Incentive Plan

In June 2005, the Company s stockholders approved an amendment and restatement of the 1997 Option Plan to become the 2005 Equity Incentive Plan (the 2005 Equity Plan). Options granted under the 1997 Option Plan prior to its amendment and restatement will continue to be subject to the terms and conditions set forth in the agreements evidencing such options and the terms of the 1997 Option Plan except that the Board may elect to extend one or more of the features of the 2005 Equity Plan to stock awards granted under the 1997 Option Plan. The approval of the 2005 Equity Plan in June 2005 increased the number of shares reserved for issuance beyond those reserved for issuance under the 1997 Option Plan by 350,000 shares for a total of 5,500,000 reserved shares. The 2005 Equity Plan will allow the Company greater flexibility in designing equity incentives, including stock appreciation rights, stock purchase awards, restricted stock awards and restricted stock unit awards. In December 2005, the Board of Directors amended the 2005 Equity Plan to reserve an additional 100,000 shares to be used only for the grant of stock awards to persons not previously employed by the Company, or following a bona fide period of non-employment, as an inducement material to those persons entering into employment with the Company with the meeting of the Rule 4350(i)(1)(A)(iv) of the

NASDAQ Marketplace Rules, and to provide that any such inducement grants must be granted either by a majority of the Company s independent directors or a committee comprised of a majority of independent directors. The following table summarizes stock option activity under the Plan and the 2005 Equity Plan for 1997 through 2005 (in thousands, except per share amounts):

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		Price Per Share	
	Shares	Range	Weighted Average
1997			
Granted	518	$ 6.75-8.70	$ 7.13
Outstanding, December 31, 1997	518	$ 6.75-8.70	$ 7.13
1998			
Granted	341	13.25-16.75	14.52
Forfeited	100	8.70	8.70
Outstanding, December 31, 1998	759	$ 6.75-16.75	$ 10.24
1999			
Granted	776	10.56-16.63	12.70
Forfeited	61	14.06-14.63	14.63
Outstanding, December 31, 1999	1,474	$ 6.75-16.75	$ 11.36
2000			
Granted	774	6.50-15.06	8.18
Exercised	1	6.75	6.75
Forfeited	24	6.75-15.13	14.22
Outstanding, December 31, 2000	2,223	$ 6.50-16.75	$ 10.22
2001			
Granted	170	3.53-11.84	6.13
Forfeited	65	5.09-16.63	13.31
Outstanding, December 31, 2001	2,328	$ 3.53-16.75	$ 9.80
2002			
Granted	696	5.15-10.10	9.48
Forfeited	55	5.13-13.13	8.17
Outstanding, December 31, 2002	2,969	$ 3.53-16.75	$ 10.98
2003			
Granted	943	2.25-17.83	6.59
Exercised	85	4.50-13.13	11.25
Forfeited	66	4.00-16.75	12.17

Outstanding, December 31, 2003	3,761	$ 2.25-17.83	$ 8.88
2004			
Granted	596	8.54-15.20	13.69
Exercised	4	3.53-5.29	3.75
Forfeited	46	10.56-17.83	13.66
Outstanding, December 31, 2004	4,307	$ 2.25-17.83	$ 9.50
2005			
Granted	408	5.22-10.75	9.94
Exercised	13	3.53-6.68	5.67
Forfeited	56	5.29-10.47	8.06
Outstanding, December 31, 2005	4,646	$ 2.25-17.83	$ 9.57

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Notes to Financial Statements (Continued)

The Company entered into stock option agreements with certain directors, officers and consultants. These options became exercisable according to a schedule of vesting as determined by the Board of Directors. During 2003, 2004 and 2005 the Company granted options to certain directors, officers, and consultants, of which some are at exercise prices below market value at the date of grant, and will recognize $730,000, $100,800, and zero, respectively, in expense related to these options over the vesting periods. Expenses related to options for consultants and directors were $630,000, $34,000, and $25,000 in 2003, 2004 and 2005, respectively. The remaining $30,000 charge for these options will be expensed over the remaining vesting period of the options.

As of December 31, 2005, the total remaining shares of common stock available for grant under the 2005 Equity Plan is 850,050 (which includes 100,000 shares under the inducement pool).

2005 Non-Employee Directors Equity Incentive Plan

The 2005 Non-Employee Directors Equity Incentive Plan (the Non-Employee Directors Plan) was approved by the Company s stockholders at the June 17, 2005 Annual Meeting of Stockholders. Under the Non-Employee Directors Plan, 150,000 shares of common stock have been reserved for issuance to non-employee directors and provides for the grant of nonstatutory stock options, stock appreciation rights, stock purchase awards, restricted stock awards, restricted stock unit awards, and other forms of equity compensation. The Board of Directors determines terms of the stock awards, including vesting requirements. The exercise price of all options granted under the Non-Employee Directors Plan must equal at least the fair market value on the date of grant. The options expire not later than ten years from the date of the grant and generally are exercisable ratably during the optionholder s continued service period. The following table summarizes stock option activity under the Non-Employee Directors Plan for 2005 (in thousands, except per share amounts):

		Price Per Share	
	Shares	Range	Weighted Average
2005			
Granted	30	$ 10.75	$ 10.75
Outstanding, December 31, 2005	30	$ 10.75	$ 10.75

Non-Plan Options

During 1995 and 1996, the Company granted non-statutory stock options to purchase a total of 608,000 shares to directors, officers and consultants. In 2004, the Company granted non-statutory stock options to purchase a total of 170,000 shares to directors and officers. In 2005, the Company did not grant any non-statutory stock options to directors or officers.

In February 1997, as part of an employment agreement, the Company granted a non-statutory stock option to an executive to purchase 2,400,000 shares of the Company s common stock at a price of $5.00 per share, which option vested ratably over a six-year period. The intrinsic value of the options was $1,848,000. As a result, the Company recorded as deferred compensation a non-cash charge of $1,848,000, which was being amortized ratably over the six-year vesting period. Through February 1999, the Company had amortized a total of $641,333. In March 1999, the Company announced the resignation of this executive, at which time the Company and the executive agreed that the option would remain outstanding for a total of 1,200,000 shares, including the acceleration of vesting of 400,000 shares. This acceleration is considered to be a new grant of options and, as such, the Company took a one-time non-cash charge of $4.9 million during the first quarter of 1999. No change was made to the terms of the option for the remaining 800,000 shares.

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In March 1999, the Company granted a non-statutory stock option to purchase 300,000 shares to an officer at an exercise price of $16.63.

On June 17, 2004, the Company granted stock options to purchase a total of 80,000 shares of common stock of the Company, at an exercise price of $11.75 per share, the fair market value of the date of grant, to two new directors. Options to purchase one-third of the total number of shares vest upon the first anniversary of the grant, and options to purchase the remaining shares vest in equal monthly installments over the following two years. At the direction of NASDAQ, with the agreement of the directors, these options were rescinded and cancelled in February 2006 and new options with the same terms were granted under the 2005 Non-Employee Directors Equity Incentive Plan. No compensation was recognized upon issuance of new options as the exercise price exceeded the stock price at the date of the new grant.

On June 24, 2004, the Company granted stock options to purchase 50,000 shares of common stock of the Company, at an exercise price of $11.70 per share, the fair market value at the date of grant, to a new executive officer. Options to purchase one-fourth of the total number of shares vest upon the first anniversary of the grant, and options to purchase the remaining shares vest in equal monthly installments over the following three years.

On September 20, 2004, the Company granted stock options to purchase 40,000 shares of common stock of the Company, at an exercise price of $10.79 per share, the fair market value at the date of grant, to a new executive officer. Options to purchase one-fourth of the total number of shares vest upon the first anniversary of the grant, and options to purchase the remaining shares vest in equal monthly installments over the following three years.

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The following table summarizes stock option activity not pursuant to the Plan for 1995 through 2005 (in thousands, except per share amounts):

		Price Per Share	
	Shares	Range	Weighted Average
1995			
Granted	38	$ 2.65-7.95	$ 4.64
Outstanding, December 31, 1995	38	$ 2.65-7.95	$ 4.64
1996			
Granted	570	2.25	2.25
Outstanding, December 31, 1996	608	$ 2.25-7.95	$ 2.40
1997			
Granted	2,400	5.00	5.00
Forfeited	50	2.25	2.25
Outstanding, December 31, 1997	2,958	$ 2.25-7.95	$ 4.51
1998			
Exercised	53	2.25-5.30	2.93
Forfeited	50	2.25	2.25
Outstanding, December 31, 1998	2,855	$ 2.25-7.95	$ 4.58
1999			
Granted	300	16.63	16.63
Exercised	10	7.95	7.95
Forfeited	1,220	2.25-5.00	4.95
Outstanding, December 31, 1999	1,925	$ 2.25-16.63	$ 6.16
Outstanding, December 31, 2000	1,925	$ 2.25-16.63	$ 6.16
2001			
Exercised	10	2.25	2.25
Outstanding, December 31, 2001	1,915	$ 2.25-16.63	$ 6.23

Outstanding, December 31, 2002	1,915	$ 2.25-16.63	$ 6.23
2003			
Forfeited	165	2.25	2.25
Outstanding, December 31, 2003	1,750	$ 2.25-16.63	$ 6.60
2004			
Granted	170	$ 10.79-11.75	$ 11.51
Outstanding, December 31, 2004	1,920	$ 2.25-16.63	$ 7.04
2005			
Granted	28	$ 6.39-7.59	$ 7.00
Exercised	22	2.25	2.25
Outstanding, December 31, 2005	1,926	$ 2.25-16.63	$ 7.09

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For various price ranges, weighted average characteristics of outstanding stock options at December 31, 2005 were as follows:

	Outstanding options			Exercisable options	
Range of Exercise Prices	Shares	Remaining life (years)	Weighted average price	Shares	Weighted average price
$ 2.25-$ 4.99	418,200	1.3	$ 2.38	418,200	$ 2.38
$ 5.00-$ 8.99	2,956,310	4.5	5.74	2,666,175	5.69
$ 9.00-$12.99	1,857,809	6.6	10.66	1,309,527	10.55
$13.00-$17.99	1,369,500	5.0	15.15	1,106,313	15.21
Balance as of 12/31/2005	6,601,819	5.0	$ 8.87	5,500,215	$ 8.51

Options exercisable at December 31, 2005, 2004 and 2003 were $5,500,215, $4,867,670 and $4,265,209 at weighted average exercise prices of $8.51, $8.14 and $8.29, respectively.

Pro Forma Disclosures of Net Loss

The Company has elected to account for its stock-based compensation plans under APB 25 (see Note 2); however, for pro forma disclosure purposes, the Company has computed the value of all options granted to employees during 2003 through 2005, using the Black-Scholes option pricing model with the following weighted average assumptions:

	2005	2004	2003
Risk free interest rate	4.02%	3.34%	3.27%
Expected divided yield	0%	0%	0%
Expected lives	5 years	5 years	5 years
Expected volatility	136%	180%	122%

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company s employee stock options have characteristics significantly different from those of traded options, and because changes in subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of the Company s options.

The weighted average, estimated fair values of employee stock options granted during fiscal 2005, 2004 and 2003 were $6.42, $11.49, and $6.31 per share, respectively.

10. Common Stock Purchase Warrants

Series A Warrants

During April 1996, in accordance with anti-dilution privileges triggered by an offering in March 1995, the Company issued 1,018,866 Series A Warrants to all stockholders of record as of March 1995 to purchase the same number of shares of common stock at a price of $11.02 per share. The warrants expired January 2002, except for one warrant for 393,250 shares, which expired January 7, 2006.

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IAC Management Warrants

During April 1994, the Company issued warrants, to existing shareholders and management, to purchase 160,000 units (the Units) at $10.00 per Unit, each unit to be identical to the Units issued as part of its initial public offering. Each Unit consists of (i) one share of common stock, $.01 par value per share and (ii) one Class A Warrant entitling the holder to purchase one share of common stock at a price of $9.00 per share. All the warrants have expired.

Representatives Warrants

In connection with the Company s initial public offering, the Company issued warrants to the underwriters for 60,000 Units at an exercise price of $11.00 per Unit and 24,000 Class B Warrants at an exercise price of $5.775 per warrant and were exercisable until May 2000. Each Class B Warrant entitled the holder to purchase one Unit (i.e. one share of common stock and one Class A Warrant). The unexercised warrants have expired.

Investor Relations Warrant

During February 1998, as part of payment for services relating to investor relations, the Company issued a warrant to purchase 150,000 shares with an exercise price of $14.75 per share and an expiration date of February 1999. The warrant was estimated to have a value of $408,000, which was expensed in 1998. This warrant was exercised.

1998 Private Placement Warrants

In connection with the May 1998 private placement, the Company issued warrants to purchase 1,437,475 shares of common stock at an exercise price of $17.00 per share. The warrants were exercisable until May 2001. Of the warrants issued, 157,000 were issued as finders fees, and 1,280,475 were issued to the private placement investors. These warrants have expired.

1999 Agent Warrants

In connection with the January 1999, private placement, the Company issued warrants as a finders fee to purchase 90,000 shares of common stock at an exercise price of $18.25 per shares. The warrants expired January 2002.

1999 Consulting Warrant

During March 1999, the Company entered into a three-year agreement with a financial consulting organization affiliated with a director of the Company. The Company agreed to issue as compensation for services, a warrant to purchase 500,000 shares of common stock with an exercise price of $20.50 per share and an expiration date of March 2002. The warrant was not subject to any vesting provisions. The warrant was estimated to have a value of approximately $2.1 million, which was expensed as a non-cash charge during the first quarter of 1999. During 2001, the expiration date for this warrant was extended to March 2003.

During March 2003, the Company amended the consulting arrangement with the same financial organization affiliated with a director. The Company amended the warrant so that the warrant is now exercisable into an aggregate of 250,000 shares of common stock with an exercise price of $10.00 per share and an expiration date of the earlier of March 12, 2006 or thirty days after the consulting agreement is terminated. A non-cash charge of approximately $0.8 million was expensed. For accounting purposes, the original warrant was considered cancelled and a new warrant issued as a replacement.

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2001 Consulting Warrants

During April 2001, the Company issued warrants to purchase 25,000 shares of common stock at an exercise price of $3.09. The warrants expire April 30, 2006. During July 2001, the Company issued warrants to purchase 25,000 shares of common stock at an exercise price of $6.225. These warrants are exercisable until July 31, 2006. These warrants, collectively, were issued for compensation for services and were estimated to have a combined value of approximately $208,000, which was expensed as a non-cash charge. Approximately 15% of these warrants have been exercised.

During the fourth quarter of 2001, the Company issued three-year warrants to purchase 16,870 shares of common stock with exercise prices ranging from $4.72 to $10.10. The warrants have no vesting period and were issued in lieu of cash for services. An estimated value for these warrants of approximately $80,000 was expensed. The majority of these warrants have not been exercised. The unexercised warrants have expired.

2001 Private Placement Warrants

In connection with the December 2001 private placement, the Company issued warrants to purchase 128,000 shares of common stock to investors with an exercise price of $12.00. Warrants to purchase 68,329 shares of our common stock were exercised and the remaining warrants expired December 11, 2003.

As a finders fee, the Company issued two warrants with an expiration date of December 11, 2006 to the placement agent for a total of 112,640 shares of common stock. One warrant has an exercise price of $9.00 and the other an exercise price of $12.00. The value ascribed to these warrants based on the Black-Scholes pricing model was $1.5 million and was included as a charge to equity. These warrants have not been exercised.

2002 Consulting Warrants

In March 2002, the Company agreed to issue a three-year warrant to a consultant, Dr. Joseph Hollis, to purchase up to 60,000 shares of common stock at an exercise price of $11.00 per share for services rendered in 2002. Dr. Hollis is the brother of Richard B. Hollis. This warrant expired with 50,000 shares unexercised.

During the fourth quarter of 2002, the Company issued a three-year warrant to purchase up to 10,000 shares of common stock at exercise price of $4.54 per share. The warrants were issued in lieu of cash for consulting services performed for the Company during 2002. The unexercised warrants have expired.

All of the 2002 warrants were valued at a total of $247,000 using the Black-Scholes pricing model. The value of the warrants was expensed and is included in the 2002 operating expenses.

2003 Convertible Note and Warrants

On February 25, 2003, the Company completed a private placement in which the Company issued $10.0 million aggregate principal amount of three-year convertible debentures (debentures), bearing interest at 7.5% per year, and warrants to purchase up to 701,760 shares of common stock. The debentures are convertible into common stock at a price of $5.70 per share, which represented a discount from the price of common stock on the commencement date. Also issued in connection with this private placement were warrants to purchase up to 350,880 shares of common stock which are exercisable at a price per share of $6.17, subject to adjustment, and warrants to purchase up to 350,880 shares of common stock which are exercisable at a price per share of $6.71, subject to adjustment. The warrants are exercisable until February 25, 2007. Approximately half of these warrants have been exercised.

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In connection with the issuance of the debentures and warrants, the Company recorded approximately $3.5 million related to the beneficial conversion feature and approximately $3.0 million for the detachable warrants on the debentures. The total amount of the deemed discount on the debentures as a result of the warrant issuance and the beneficial conversion feature amounts to $6.5 million. The beneficial conversion feature and warrant value (deemed discount) were amortized over the term of the debentures and as conversion of the debentures occurred.

The placement agent received a warrant to purchase 73,684 shares of common stock having an exercise price of $5.99 per share. This warrant is exercisable until February 25, 2008. The value ascribed to this warrant based on the Black-Scholes pricing model was $0.4 million and was expensed as a non-cash charge. This warrant has not been exercised.

2003 Private Placement Warrants

In connection with the June 2003 private placement, the Company issued warrants to purchase 192,456 shares of common stock to investors with an exercise price of $15.45. These warrants expire June 19, 2007. These warrants have not been exercised.

As a finders fee, the Company issued a warrant with an expiration date of June 19, 2008 to the placement agent, for a total of 44,266 shares of common stock with an exercise price of $13.22. The value ascribed to this warrant based on the Black-Scholes pricing model was $0.5 million and was charged to equity. This warrant has not been exercised.

2004 Consulting Warrants

During 2004, the Company issued two two-year warrants to purchase up to a total of 12,000 shares of common stock at exercise prices of $10.15 and $11.75 per share. The warrants were issued for consulting services performed for the Company.

The 2004 warrants were valued at a total of $108,280 using the Black-Scholes pricing model. The value of the warrants is amortized according to the vesting period which approximates the period over which the services are performed. In 2004, $102,860 was expensed and is included in the 2004 operating expenses. The additional $5,420 was expensed in 2005, over the remaining vesting period.

2005 Financing Warrants

In connection with the June 2005 subscription agreement with a single institutional investor, the company issued a four-year warrant to purchase up to an additional 266,667 shares of common stock at an exercise price of $10.00 per share. The value ascribed to this warrant based on the Black-Scholes pricing model was $1.8 million and was charged to equity. This warrant has not been exercised.

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The following table summarizes stock warrant activity for 2003 through 2005 (in thousands, except per share amounts):

		Price Per Share	
	Shares	Range	Weighted Average
Outstanding, December 31, 2002	1,371	$ 3.09-20.50	$ 13.97
2003			
Issued	1,262	5.99-15.45	8.73
Exercised	467	3.09-15.45	7.49
Forfeited	579	3.09-20.50	19.26
Outstanding, December 31, 2003	1,587	$ 3.09-15.45	$ 9.85
2004			
Issued	12	10.15-11.75	11.22
Exercised	6	4.72-10.10	5.15
Forfeited	6	4.72-10.10	6.99
Outstanding, December 31, 2004	1,587	$ 3.09-15.45	$ 9.82
2005			
Issued	267	10.00	10.00
Exercised	42	6.17	6.17
Forfeited	160	4.54-11.00	9.66
Outstanding, December 31, 2005	1,652	$ 3.09-15.45	$ 9.96

For various price ranges, the following table summarizes the weighted average prices of outstanding warrants as of December 31, 2005 (in thousands, except per share amounts):

	Outstanding Warrants		Exercisable Warrants	
Range of Exercise Prices	Shares	Weighted average price	Shares	Weighted average price
$ 3.00-$ 5.00	21	$ 3.09	21	$ 3.09

$ 5.01-$10.00	993	8.51	993	8.51
$10.01-$15.00	459	11.26	459	11.26
$15.01-$20.00	179	15.45	179	15.45
Balance as of 12/31/2005	1,652	$ 9.96	1,652	$ 9.96

The weighted average fair value of warrants issued in fiscal years 2005, 2004 and 2003 were $9.96, $9.82 and $9.79, respectively.

11. Employment Agreement

Pursuant to an employment agreement between Hollis-Eden and Mr. Richard B. Hollis entered into in November 1996 (the Hollis Employment Agreement), Mr. Hollis annual base salary was increased to $225,000 upon the consummation of the Merger, with bonuses, future salary increases and equity compensation as determined by the Hollis-Eden Pharmaceuticals Board of Directors. Effective January 1, 2005, Mr. Hollis base salary was increased from $485,000 to $500,000. If Mr. Hollis employment is terminated without cause,

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Notes to Financial Statements (Continued)

for insufficient reason or pursuant to a change in control (as such terms are defined in the Hollis Employment Agreement), Mr. Hollis will receive as severance (i) an amount equal to five times his then current annual base salary plus five times the amount of the bonus awarded to him in the prior calendar year, (ii) immediate vesting of all unvested stock options of Hollis-Eden Pharmaceuticals (or the surviving corporation in a change in control, if applicable) held by him and (iii) continued benefits under all employee benefit plans and programs for a period of three years. All of such payments are to be made in one lump sum within 30 days of termination. If Mr. Hollis employment is terminated with cause or if Mr. Hollis resigns other than for sufficient reason, Mr. Hollis compensation and benefits will cease immediately and Mr. Hollis will not be entitled to severance benefits.

12. Leases

Rental expenses for principal leased facilities under non-cancelable operating leases were approximately $888,000, $902,000, and $754,000 for 2005, 2004 and 2003 respectively. Future minimum payments for operating leases are as follows (in thousands):

	Operating Leases
2006	$ 926
2007	666
2008	23
2009	9
Total minimum lease payments	$ 1,624

13. Subsequent Event

On February 6, 2006 the Company raised approximately $26.0 million in gross proceeds from the sale of 4,000,000 shares of the Company s common stock at an exercise price of $6.50 per share. The direct costs related to this financing were $1.6 million, resulting in net proceeds of $ 24.4 million. Additionally, the Company issued four-year warrants to purchase up to an additional 800,000 shares of common stock at an exercise price of $8.75 per share. The warrants are not exercisable until six months following issuance.

On January 9, 2006, the Company entered into a Settlement Agreement and General Release of Claims with certain former warrant holders of the Company who had made various allegations against the Company in connection with warrants that expired in January 2002. Although the Company denied all such allegations, the Company agreed to settle all disputes between the parties. As part of the Settlement Agreement, the former warrant holders received compensation from the Company and the Company s insurance carrier. The Company s portion of such settlement is $540,000, which is accrued for at December 31, 2005 and will be paid by the Company prior to April 9, 2006.

Hollis-Eden Pharmaceuticals, Inc.

(A Development Stage Company)

Notes to Financial Statements (Continued)

14. Supplementary Financial Data (Unaudited)

Interim Financial Information

(Unaudited)

	March	June	September	December	Year
	(In thousands, except per share)				
Year Ended December 31, 2005					
R&D operating expenses	$ 5,344	$ 4,173	$ 4,152	$ 5,041	$ 18,710
G&A operating expenses	1,776	2,736	1,957	2,909	9,378
Non-cash charges	12	6	6	7	31
Net loss	6,812	6,538	5,661	10,430	29,441
Net loss per share	(0.35)	(0.33)	(0.27)	(0.50)	(1.46)
Cash and cash equivalents	54,198	55,908	51,451	45,130	45,130
Year Ended December 31, 2004					
R&D operating expenses	$ 4,665	$ 3,425	$ 4,259	$ 6,566	$ 18,915
G&A operating expenses	1,429	1,693	1,483	2,048	6,653
Non-cash charges	12	15	71	38	136
Net loss	5,901	4,879	5,586	8,391	24,757
Net loss per share	(0.31)	(0.25)	(0.29)	(0.44)	(1.28)
Cash and cash equivalents	79,215	73,116	68,177	61,991	61,991

Quarterly and year-to-date computations of loss per share amounts are made independently. Therefore, the sum of the per share amounts for the quarter may not agree with the per share amounts for the year.

Fourth Quarter Adjustments

In the fourth quarter of fiscal 2005, the Company recorded a $3,000,000 accrual relating to a settlement of a dispute, which is shown separately on the statement of operations (see Note 6). In addition, the Company recorded a $540,000 accrual related to a Settlement Agreement and General Release of Claims with certain former warrant holders, which is included in general and administrative operating expenses (See Note 13).

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Hollis-Eden Pharmaceuticals, Inc.

San Diego, California

We have audited the accompanying balance sheets of Hollis-Eden Pharmaceuticals, Inc. (the Company) (a development stage company) as of December 31, 2005 and 2004 and the related statements of operations, stockholders equity and cash flows for each of the years in the three-year period ended December 31, 2005 and for the period from inception (August 15, 1994) to December 31, 2005. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Hollis-Eden Pharmaceuticals, Inc. as of December 31, 2005 and 2004, and the results of its operations and cash flows for each of the years in the three year period ended December 31, 2005 and for the period from inception (August 15, 1994) to December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of December 31, 2005, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 10, 2006 expressed an unqualified opinion thereon.

/s/ BDO Seidman, LLP

Costa Mesa, California

March 10, 2006

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Hollis-Eden s management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Exchange Act Rule 13a-15(e) 15d-15(e). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in enabling the Company to record, process, summarize and report information required to be included in the Company s periodic SEC filings within the required time period.

Management s Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for Hollis-Eden. Hollis-Eden s internal control system was designed to provide reasonable assurance to Company management and board of directors regarding the preparation and fair presentation of published financial statements in accordance with accounting principles generally accepted in the United States of America.

Management recognizes its responsibility for fostering a strong ethical climate so that the Company s affairs are conducted according to the highest standards of personal and corporate conduct.

The Company s internal control over financial reporting includes those policies and procedures that:

pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;

provide reasonable assurance that transactions are recorded properly to allow for the preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and Directors of the Company;

provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company s assets that could have a material effect on the financial statements; and provide reasonable assurance as to the detection of fraud.

Because of its inherent limitations, a system of internal control over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Further, because of changing conditions, effectiveness of internal control over financial reporting may vary over time. The Company s processes contain self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

Management has assessed the effectiveness of Hollis-Eden s internal control over financial reporting as of December 31, 2005, based on the criteria for effective internal control described in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on its assessment, management concluded that the Company s internal control over financial reporting was effective as of December 31, 2005.

BDO Seidman LLP, the independent registered public accounting firm that audited the financial statements included in this Annual Report on Form 10-K, was engaged to attest to and report on management s assessment of the effectiveness of Hollis-Eden s internal control over financial reporting as of December 31, 2005. Its report is included herein.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of

Hollis-Eden Pharmaceuticals, Inc.

San Diego, California

We have audited management s assessment, included in the accompanying *Management s Report on Internal Control over Financial Reporting*, that Hollis-Eden Pharmaceuticals, Inc. (the Company) maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that the Company maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements as of December 31, 2005 and 2004 and the related statements of operations, stockholders equity and cash flows for each of the years in the three year period ended December 31, 2005 and for the period from inception (August 15, 1994) to December 31, 2005, and our report dated March 10, 2006 expressed an unqualified opinion on those financial statements.

/s/ BDO Seidman, LLP

Costa Mesa, California

March 10, 2006

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Changes in Internal Control over Financial Reporting

There were no changes in Hollis-Eden s internal controls over financial reporting that occurred during the quarter ended December 31, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

At its meeting on February 13, 2006, the Compensation Committee of the Board of Directors took the following actions with respect to the compensation of the Company s named executives officers (as defined in Regulation S-K item 402(a)(3)):

Executive Officer	2006 Base Salary	2005 Bonus
Richard B. Hollis Chairman of the Board, President and Chief Executive Officer	$ 512,500	$ 250,000
Dwight R. Stickney, M.D. Vice President, Medical Affairs	343,375	40,000
Daniel D. Burgess Chief Operating Officer and Chief Financial Officer	330,050	40,000
James M. Frincke, Ph.D. Chief Scientific Officer	287,000	40,000
Eric J. Loumeau Vice President, Corporate General Counsel	261,375	35,000

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PART III

Item 10. Directors and Executive Officers of the Registrant

See the section entitled Executive Officers and Senior Management in Part I, Item 1 hereof for information regarding executive officers and senior management.

The other information required by this item is incorporated by reference from Hollis-Eden s definitive Proxy Statement to be filed with the Commission pursuant to Regulation 14A in connection with the Hollis-Eden s 2006 Annual Meeting (the Proxy Statement).

Item 11. Executive Compensation

The information required by this item is incorporated by reference to the disclosures under the heading Executive Compensation in the Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information regarding certain beneficial owners and management required by this item is incorporated by reference to the disclosures under the heading Security Ownership of Certain Beneficial Owners and Management in the Proxy Statement.

The following table provides information as of December 31, 2005 with respect to all of our compensation plans under which we are authorized to issue equity securities of the company.

Equity Compensation Plan Information

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities in the first column)
Stock option equity compensation plans approved by security holders	4,676,119	$ 9.58	870,050
Stock option equity compensation plans not approved by security holders	1,925,700	$ 7.09	

Warrant equity compensation plans not approved by security holders	796,386	$ 10.17	
Total	7,398,205		870,050

The material features of each compensation plan or arrangement adopted without the approval of securities holders is included in Note 9 (Stock Options Non-Plan Options) and Note 10 (Common Stock Purchase Warrants) in our Notes To Financial Statements.

Unregistered Sales of Equity Securities and Use of Proceeds

We made no unregistered sales of securities or repurchases of our securities during the quarter or year ended December 31, 2005.

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Item 13.　　Certain Relationships and Related Transactions

The information required by this item is incorporated by reference to the disclosures under the heading Certain Transactions, which information is incorporated herein by reference.

Item 14.　　Principal Accountant Fees and Services

The information concerning Principal Accountant Fees and Services is set forth in the Proxy Statement under the heading Ratification of Selection of Independent Auditors in the Proxy Statement which information is incorporated herein by reference.

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PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) The following documents have been filed as part of this Annual Report to Stockholders on Form 10-K:

1. *Financial Statements:* The information required by this item is included in Item 8 of Part II of this report.

2. *Financial Statement Schedules:* Financial statement schedules required under the related instructions are not applicable for the three years ended December 31, 2005, and have therefore been omitted.

3. *Exhibits:* The exhibits listed in the Exhibit Index attached to this report are filed or incorporated by reference as part of this Annual Report.

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SIGNATURES

Pursuant to the requirements of the Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

HOLLIS-EDEN PHARMACEUTICALS, INC.

By: /s/ RICHARD B. HOLLIS
Richard B. Hollis,

Chairman of the Board of Directors,

Chief Executive Officer, President and Director

Date: March 10, 2006

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints RICHARD B. HOLLIS, DANIEL D. BURGESS and ROBERT W. WEBER, and each of them, as his true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place, and stead, in any and all capacities, to sign any and all amendments to this Report, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming that all said attorneys-in-fact and agents, or any of them or their or his substitute or substituted, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons in the capacities and on the dates indicated.

Signature	Title	Date
/s/ RICHARD B. HOLLIS **Richard B. Hollis**	Chairman of the Board of Directors, Chief Executive Officer, President And Director	March 10, 2006
/s/ DANIEL D. BURGESS **Daniel D. Burgess**	Chief Operating Officer/Chief Financial Officer (Principal Financial Officer)	March 10, 2006
/s/ ROBERT W. WEBER **Robert W. Weber**	Chief Accounting Officer and Vice President Controller (Principal Accounting Officer)	March 10, 2006
/s/ PAUL BAGLEY **Paul Bagley**	Director	March 10, 2006

/s/ Jerome M. Hauer **Jerome M. Hauer**	Director	March 10, 2006
/s/ Brendan R. McDonnell **Brendan R. McDonnell**	Director	March 10, 2006
/s/ Thomas C. Merigan, Jr. M.D. **Thomas C. Merigan, Jr. M.D.**	Director	March 10, 2006
/s/ Marc R. Sarni **Marc R. Sarni**	Director	March 10, 2006
/s/ Salvatore J. Zizza **Salvatore J. Zizza**	Director	March 10, 2006

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INDEX TO EXHIBITS

Exhibit Number	Description of Document
*3.1	Amended and Restated Certificate of Incorporation of the Registrant (incorporated by reference to Exhibit 4.1 to Registrant s Registration Statement on Form S-4 (No. 333-18725), as amended (the Form S-4)).
*3.2	Bylaws of Registrant (incorporated by reference to Exhibit 4.2 to the Form S-4).
*3.3	Certificate of Designation of Series B Junior Participating Preferred Stock (incorporated by reference to Exhibit 4.1 to Registrant s Current Report on Form 8-K dated November 15, 1999).
*3.4	Certificates of Amendment of Certificate of Incorporation (incorporated by reference to Exhibit 3.4 to Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2001.)
*4.1	Rights Agreement dated as of November 15, 1999 among Registrant and American Stock Transfer and Trust Company (incorporated by reference to Exhibit 99.2 to the Registrant s Current Report on Form 8-K dated November 15, 1999).
* 10.1	Registrant s 1997 Incentive Stock Option Plan (the Option Plan) as amended (incorporated by reference to Exhibit 10.1 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).
* 10.2	Forms of Incentive Stock Options and Nonstatutory Stock Options under the Option Plan (incorporated by reference to Exhibit 10.5 to the Form S-4).
* 10.3	Form of Nonstatutory Stock Options outside the Option Plan (including Annex I, identifying the officers and directors who are holders of such options and their respective option amounts and exercise prices), (incorporated by reference to Exhibit 10.3 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).
* 10.4	Employment Agreement by and between Registrant and Richard B. Hollis dated November 1, 1996 (incorporated by reference to Exhibit 10.6 to the Form S-4).
* 10.5	Employment Agreement by and between Registrant and Robert W. Weber dated March 16, 1996 (incorporated by reference to Exhibit 10.9 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 1998).
* 10.6	Consulting Agreement and Warrant by and between Registrant and William H. Tilley and Jacmar/Viking, L.L.C. dated March 8, 1999 (incorporated by reference to Exhibit 10.5 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 1999).
* 10.7	Amendments to Consulting Agreement and Warrant by and between Registrant and William H. Tilley and Jacmar/Viking L.L.C. dated March 12, 2001 (incorporated by reference to Exhibit 10.7 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).
* 10.8	Nonstatutory Stock Option by and between Registrant and Terren S. Peizer effective as of February 6, 1997 (incorporated by reference to Exhibit 10.8 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).
* 10.9	Separation and Mutual Release Agreement by and between Registrant and Terren S. Peizer effective as of February 25, 1999 (incorporated by reference to Exhibit 10.10 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended March 31, 1999).
* 10.10	Nonstatutory Stock Option by and between Registrant and Richard B. Hollis effective as of January 1, 1999 (incorporated by reference to Exhibit 10.10 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).

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Exhibit Number	Description of Document
* 10.11	Promissory Note, as amended, by and between Registrant and Richard B. Hollis dated May 22, 1998 (incorporated by reference to Exhibit 10.11 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).
* 10.12	Hollis-Eden Pharmaceuticals, Inc. Series A Warrant Agreement dated May 20, 1997, by and between Registrant and Richard B. Hollis, as amended on May 5, 2000 (incorporated by reference to Exhibit 10.12 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).
* 10.13	Employment Agreement by and between Registrant and Daniel D. Burgess dated July 9, 1999 (incorporated by reference to Exhibit 10.10 to Registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 1999).
* 10.14	Employment Agreement by and between Registrant and Eric J. Loumeau dated September 15, 1999 (incorporated by reference to Exhibit 10.11 to Registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 1999).
* 10.15	Hollis-Eden Pharmaceuticals Unit Warrant, dated April 23, 1994, by and between Registrant and Salvatore J. Zizza, as amended on March 18, 2002 (incorporated by reference to Exhibit 10.15 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2002).
*10.16	Settlement and Mutual Release Agreement, dated January 20, 2000, among Registrant, Colthurst Limited, Edenland, Inc. and Patrick T. Prendergast (incorporated by reference to Exhibit 99.2 to Registrant s Current Report on Form 8-K dated January 20, 2000).
*10.17	Technology Assignment Agreement, dated January 20, 2000, among Registrant, Colthurst Limited and Patrick T. Prendergast (incorporated by reference to Exhibit 99.3 to Registrant s Current Report on Form 8-K dated January 20, 2000).
*10.18	Common Stock and Warrant Agreement, dated January 20, 2000, among Registrant and Colthurst Limited (incorporated by reference to Exhibit 99.4 to Registrant s Current Report on Form 8-K dated January 20, 2000).
*10.19	Warrant, dated January 20, 2000, issued to Colthurst Limited (incorporated by reference to Exhibit 99.5 to Registrant s Current Report on Form 8-K dated January 20, 2000).
*10.20	Indemnification Agreement among Registrant and Executive Officers and Directors (incorporated by reference to Exhibit 10.17 to Registrant s Registration Statement on Form S-1 (No. 333-69454).
*10.21	Hollis-Eden Pharmaceuticals, Inc. Discretionary Contribution Plan and Trust Agreement (incorporated by reference to Exhibit 99.2 to Registrant s Registration Statement on Form S-8 (No. 333-92185)).
*10.22	Form of Stock and Warrant Purchase Agreement, dated as of December 11, 2001, between the Registrant and the purchasers listed on Schedule I attached thereto (incorporated by reference to Exhibit 4.4 to the Registrant s Registration Statement on Form S-3 (No. 333-75860)).
*10.23	Form of Warrant, dated December 11, 2001, issued to the purchasers listed on Schedule I thereto (incorporated by reference to Exhibit 4.5 to the Registrant s Registration Statement on Form S-3 (No. 333-75860)).
*10.24	Form of Warrant issued to H.C. Wainwright & Co., Inc. in the amounts and on the dates listed on Schedule I attached thereto (incorporated by reference to Exhibit 4.6 to the Registrant s Registration Statement on Form S-3 (No. 333-75860)).

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Exhibit Number	Description of Document
*#10.25	Patent License Agreement between the Registrant and Dr. Roger M. Loria (incorporated by reference to Exhibit 10.1 to the Registrant s Registration Statement on Form S-3 (No. 333-75860)).
*10.26	Sublease dated December 19, 2001 between Cooley Godward LLP and Registrant (incorporated by reference to Exhibit 10.16 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2001).
*10.27	Securities Purchase Agreement, dated as of February 25, 2003, by and between Hollis-Eden Pharmaceuticals, Inc. and the purchasers identified therein (incorporated by reference to Exhibit 10.27 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2002).
*10.28	Form of 7.5% Convertible Debenture issued to the purchasers listed on Schedule I attached thereto on February 25, 2003 (incorporated by reference to Exhibit 10.28 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2002).
*10.29	Form of Stock Purchase Warrant issued to purchasers listed on Schedule I attached thereto on February 25, 2003 (incorporated by reference to Exhibit 10.29 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2002).
*10.30	Registration Rights Agreement, dated February 25, 2003, by and between Hollis-Eden Pharmaceuticals, Inc. and the purchasers identified therein (incorporated by reference to Exhibit 10.30 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2002).
*10.31	Warrant, dated February 25, 2003, issued to SG Cowen Securities Corporation (incorporated by reference to Exhibit 10.30 to the Registrant s Annual Report on Form 10-K for the year ended December 31, 2002).
*10.32	Registration Rights Agreement, dated June 19, 2003, by and between Hollis-Eden Pharmaceuticals, Inc. and the purchasers identified therein. (incorporated by reference to Exhibit 4.4 to the registrant s Registration Statement On Form S-3 (No. 333-106835).
*10.33	Form of Stock Purchase Warrant issued to purchasers listed on Schedule I attached thereto on June 19, 2003 (incorporated by reference to Exhibit 4.2 to the Form S-3 (No. 333-106835)).
*10.34	Warrant issued to SG Cowen Securities Corporation on June 19, 2003 (incorporated by reference to Exhibit 4.3 to the Form S-3 (No. 333-106835)).
*#10.35	Study funding Agreement, dated as of June 17, 2003, between the registrant and Cystic Fibrosis Foundation Therapeutics, Inc (incorporated by reference to Exhibit 10.1 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).
*10.36	Amendments to Consulting Agreement and Warrant by and between the registrant and William H. Tilley and Jacmar/Viking, L.L.C. dated March 11, 2003 (incorporated by reference to Exhibit 10.2 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003).
*10.37	Amended 401(k) Plan (incorporated by reference to Exhibit 10.1 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 2003).
*10.38	First Amendment to Sublease dated December 19, 2001 between Cooley Godward LLP and Registrant.
*10.39	Form of Common Stock Purchase Warrant issued on June [1,] 2005 (incorporated by reference to Exhibit 10.41 to the Registrant s Current Report on Form 8-K dated June 2, 2005).

Exhibit Number	Description of Document
*#10.40	Letter Agreement between Cystic Fibrosis Foundation Therapeutics, Inc. and the Company entered into on December 3, 2003 (incorporated by reference to Exhibit 10.42 to the Registrant s Amendment No. 1 on Form 10-Q/A to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2005).
*#10.41	Letter Agreement between Cystic Fibrosis Foundation Therapeutics, Inc. and the Company entered into on February 17, 2004 (incorporated by reference to Exhibit 10.43 to the Registrant s Amendment No. 1 on Form 10-Q/A to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2005).
*#10.42	Letter Agreement between Cystic Fibrosis Foundation Therapeutics, Inc. and the Company dated July 12, 2004 (incorporated by reference to Exhibit 10.44 to the Registrant s Amendment No. 1 on Form 10-Q/A to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2005).
*#10.43	Letter Agreement between Cystic Fibrosis Foundation Therapeutics, Inc. and the Company dated October 19, 2004 (incorporated by reference to Exhibit 10.45 to the Registrant s Amendment No. 1 on Form 10-Q/A to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2005).
*#10.44	Letter Agreement between Cystic Fibrosis Foundation Therapeutics, Inc. and the Company dated January 6, 2005 (incorporated by reference to Exhibit 10.46 to the Registrant s Amendment No. 1 on Form 10-Q/A to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2005).
*#10.45	Letter Agreement between Cystic Fibrosis Foundation Therapeutics, Inc. and the Company dated May 16, 2005 (incorporated by reference to Exhibit 10.47 to the Registrant s Amendment No. 1 on Form 10-Q/A to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2005).
* 10.46	2005 Equity Incentive Plan, as amended (incorporated by reference to Exhibit 99.2 to the Registrant s Registration Statement on Form S-8 (No. 333-130670), filed December 23, 2005).
* 10.47	Form of Option Agreement for use under 2005 Equity Incentive Plan, as amended (incorporated by reference to Exhibit 99.2 to the Registrant s Registration Statement on Form S-8 (No. 333-130670), filed December 23, 2005).
* 10.48	Form of Restricted Stock Award Agreement for use under 2005 Equity Incentive Plan, as amended (incorporated by reference to Exhibit 99.2 to the Registrant s Registration Statement on Form S-8 (No. 333-130670), filed December 23, 2005).
* 10.49	Form of Restricted Stock Unit Award Agreement for use under 2005 Equity Incentive Plan, as amended (incorporated by reference to Exhibit 99.2 to the Registrant s Registration Statement on Form S-8 (No. 333-130670), filed December 23, 2005).
* 10.50	2005 Non-Employee Directors Equity Incentive Plan, as amended
* 10.51	Form of Option Agreement for use under 2005 Non-Employee Directors Equity Incentive Plan (incorporated by reference to Exhibit 99.2 to the Registrant s Registration Statement on Form S-8 (No. 333-130670), filed December 23, 2005).
#10.52	Letter Agreement between Cystic Fibrosis Foundation Therapeutics, Inc. and the Company dated November 30, 2005.
23.1	Consent of BDO Seidman, LLP.
31.1	Rule 13a-14(a)(15d-14(a) Certification of Richard B. Hollis.
31.2	Rule 13a-14(a)(15d-14(a) Certification of Daniel D. Burgess.
32.1	Section 1350 Certifications of Richard B. Hollis and Daniel D Burgess.

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* Previously filed.

Management contract or compensatory plan, contract or arrangement to be filed as an exhibit pursuant to Item 14(c) of Form 10-K.

\# Confidential treatment has been granted with respect to certain portions of this exhibit. Omitted portions have been filed separately with the Securities and Exchange Commission.