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CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

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COMMITTEE ON FINANCE

MAX BAUCUS, Montana, *Chairman*

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CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION

THURSDAY, APRIL 18, 2002

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:35 a.m., in room 215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Also present: Senators Lincoln, Grassley, Gramm, and Thomas.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Good morning, everyone. A particularly good morning to Senator Levin and Senator Enzi. We very much appreciate your participating this morning.

Today we are addressing some interrelated issues of corporate governance and executive compensation. Based upon questions that have arisen with the collapse of Enron, we have been inundated with reports of accounting restatements, disclosure concerns, SEC files, and so forth.

Congress certainly is reacting to all of these questions. There must be, what, over a dozen, two dozen committees and subcommittees in the Congress who have held hearings on issues related to Enron. Now we in the Congress are starting to turn to legislation.

For our part, the Finance Committee is working on three pieces of legislation: pensions, tax shelters, and executive compensation and stock options. Other committees are looking at accounting standards and oversight, financial reporting, insider trading, and the liability of corporate directors.

At the same time, corporations are also reacting themselves from the collapse of Enron. Some of them are reforming their practices. We now seek delays in financial reports as internal changes are made to reflect improved, and probably more conservative, accounting practices. The Financial Accounting Standards Board is considering reforms, and the Securities Exchange Commission appears to be cracking down on enforcement.

With that in mind, however, I think it is also critical for us to take a couple of steps back from the canvas and look at the larger picture. Before we go down this road too far, I think it is important to take a good look at what we are doing, where we are, and what got us to this point.

Otherwise, this committee and every other relevant committee will be working somewhat with blinders on. The committees will not be paying as much attention as they should be to what other committees are doing.

I want to ensure that, if legislation is enacted to address problems highlighted by the Enron collapse, that that legislation is meaningful, that it is effective, that we not miss our mark on behalf of employees, on behalf of investors, on behalf of consumers.

The goal here is to inspire more confidence and to help Americans believe in our economic system where an investor has a reasonable sense of what his or her return might be, stockholders have a sense of what their company is or is not doing, directors have a sense of what their company is not doing, better than today.

That is where our first panel comes in. The subject, broadly put, is corporate governance. In other words, the system of oversight and management of a corporation carried out by the board of directors, by management, and investors.

I am told that the Enron collapse is really symptomatic of a broader problem with corporate governance. In a nutshell, too many people are supposed to provide disinterested expertise, but instead have a stake in that outcome that prevents them from fully serving investors, fully serving potential investors, the public, and stockholders and the public at large.

An example, is the increasing number of earning statements that have to be corrected to provide more accurate accounting. Alan Greenspan recently said that, "CEOs, under increasing pressure from the investment community to meet short-term elevated expectations, in too many instances have been drawn to accounting devices whose sole purpose is arguably to obscure potential adverse results. Outside auditors have sanctioned such devices, allegedly for fear of losing value corporate clients."

Big questions of corporate governance are at the heart of the problems at Enron and at other companies. We must keep these questions firmly in mind as we do our work here on the Finance Committee.

The second panel is about a related, but much more specific, issue: executive compensation. Executive compensation in the Enron context is, in many respects, the flip side of the pension question.

Rank and file workers at Enron and thousands of companies across the country participate in qualified pension plans such as defined benefit plans and 401(k) plans. We discovered, with the Enron example, that it is possible for workers to lose a lifetime's worth of savings in their plans.

But media reports indicate that some executives may not be playing by the same rules they are imposing on their employees. Rank and file Enron employees lost their pension savings. Now they must stand in line as part of the bankruptcy proceeding.

In contrast, it appears that some Enron executives received their executive compensation without being subject to the same bankruptcy process. They protected their pension savings.

The Finance Committee is going to fully explore these reports. If it turns out that the reports are true, we are going to figure out how it happened, how widespread the practice was, and whether our laws should be changed to avoid similar outcomes in the future.

Another aspect of executive compensation is stock options. Today, stock options comprise an increasing percentage of the typical CEO's pay package, and efforts have been made in the past to explore their treatment for accounting purposes. A number of our witnesses today will discuss both the tax and the accounting questions.

Finally, our original panel included a witness who would have helped the committee understand an issue known as split-dollar life insurance. Split-dollar life raises issues associated with executive compensation and is appropriate in any compensation exploring the deferral of taxation on income. But, unfortunately, our witness will not be able to appear today and we will pursue this issue at a later date.

I am confident that Congress will be exploring issues related to Enron's bankruptcy for a long time to come, not only this year, but I am sure they will extend into next year.

Many of these problems are complex and do not lend themselves to easy resolutions. I look forward to learning from our witnesses today as we begin the discussion of the issues. It is my purpose that this committee will explore these issues very thoroughly. This is not intended to be a witch hunt, nor is it intended to be a white wash.

Rather, it is intended to ask that second, third, and fourth level of questions. It is going to take some time. It is not glamorous, but with a view toward helping in the long run to restore greater confidence in America, investor confidence, consumer confidence, and employee confidence, and American confidence that our companies are being well run and that financials accurately state the financial picture of a company.*

Senator Grassley?

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Mr. Chairman, I have a 14-page statement I want to put in the record, and I will summarize very quickly this way.

Obviously, I thank you for holding these hearings because these hearings ought to be looked into. I am willing to look at these issues. I may not be as convinced as some of my colleagues that it is necessary to legislate in this area, but when it comes to Enron in a global picture and all of the abuses and deprivation of employee savings that have gone down the drain, there does need to be legislation in some areas that we not only see as a need to pass, but we want to make sure that it passes, and passes this year.

In my statement, I say that we might be able to resolve some of the concerns about perceived abuse of non-qualified compensation if we permit the Internal Revenue Service to issue regulations in some of the areas that have been questioned as improper.

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*For more information on this subject, *see also*, "Present Law and Background Relating to Executive Compensation," Joint Committee on Taxation staff report, April 17, 2002 (JCX–29–02).

Also, while I agree with you, Senator Levin, on your objectives in wanting to make companies' financial statements more transparent, I do not believe that that objective can be accomplished through the Tax Code.

Any inadequacies in making security more transparent, I think, needs to be done, although I guess I believe that if the spirit of the 1930's legislation is carried out, transparency is the basis of that legislation. We have to do things to make sure that that spirit is carried out. I hope that we can find other ways to help investors understand the financial conditions of corporations that they help to finance.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. We are very honored today to have two colleagues here before us. Senator Levin and Senator Mike Enzi, we understand that you have very busy schedules today, but you want to also address this very important issue before us today.

So, when you have finished your testimony, if you want to leave, that is certainly fine with this committee. But, more than that, we are very happy to have you here and have you testify.

Senator Levin?

STATEMENT OF HON. CARL LEVIN, A U.S. SENATOR FROM MICHIGAN

Senator LEVIN. Mr. Chairman and Senator Grassley, thank you for inviting us to testify. Thank you for holding this hearing. It is really a very timely and a very appropriate hearing, indeed, coming on the heels of the Enron collapse, that we look at the operations of corporate America, see how corporations are governed. There are many aspects to it, as both of you have pointed out.

One of those aspects is the issue of executive pay and the way in which the Tax Code treats executive pay. Ten years ago, my Subcommittee on Governmental Affairs decided to look into the matter of CEO pay.

Back them, the business publications were expressing shock at the gap, the disconnect between CEO pay and what average workers were making. At that time 10 years ago, CEOs were making over 100 times average worker pay. When we compared that gap here to other countries, we found a huge difference. CEO pay in the United States was multiples of what CEO pay was in other countries. Well, that is 10 years ago.

Now, this chart shows what has happened since 1990. In 1990, CEOs were making 109 times what the average worker was making. By 1995, that was up to 183 times. Now it is 522 times. That is not a gap, that is a chasm.

To put a little context on that, J.P. Morgan, not one who took a back seat to anybody in supporting and rewarding top executives, one of our country's leaders, said that CEO pay should not exceed 20 times that of the average worker's pay.

Now, when we looked at what has happened in these 10 years to create these rates of compensation and these gaps between average person's pay and CEO pay, we learn that one major factor was stock options. Designed to be a tool to link pay to performance, they have been awarded now in such huge amounts and in such ways that they have defeated that intent.

Many articles in the last few months have described companies where CEO stock option pay has soared, despite poor company performance. Global Crossing went bankrupt while its CEO made $730 million in stock option income in a single year.

Oracle Computer stock price dropped 57 percent in the same year that its CEO cashed in stock options for $700 million. Sysco Systems stock price dropped 72 percent in the same year that it gave its CEO 6 million new stock options.

Other companies repriced options that had lost value after stock prices dropped or issued additional options so that executives would benefit even when stockholders of that company lost.

Now, how does that happen? It happens because of our Tax Code. Stock options are the only form of compensation not required to be reported as an expense on a company's books, but are nonetheless given a tax deduction.

It is a double standard. They do not show as an expense on the company's books, and yet we give them an expense on their tax returns. It is a double standard which makes no sense and it is a double standard that the Tax Code has created.

I happen to be one that believes that government should not be setting limits on compensation or the amounts of corporate compensation for executives. But we write the Tax Code. It is up to us to decide whether or not we should allow a business expense deduction for something which does not show as a business expense on the company's own books.

This is stealth compensation because it does not show as an expense on the company's books. It does not affect the company's bottom line like every other single form of compensation.

There is no other form of compensation which does not have to be shown as an expense on the company's books. If a company gives a bonus for performance, that bonus has to show as an expense on the company's books. If a company says we are going to give you stock as a reward for performance, that stock value must show as an expense on the company's books.

The only exception, is stock options. If a company decides not to expense stock options, if that is their decision—and by the way, some companies do expense stock options on their books. There are a few. But if a company decides not to do it, it nonetheless gets a tax deduction for that tax option expense.

So I happen to agree with what Senator Grassley said. I do not think we should be legislating executive compensation. That is not government's role. But the Tax Code is written by us. It is up to us as to whether or not, if a company does not show options as an expense, we want to give them a tax deduction, nonetheless.

Enron related on stock options this double standard to inflate its earnings. From 1996 to 2000, Enron told its stockholders it was rolling in revenues, took stock option expenses as tax deductions to the extent of $600 million during those same years, avoided paying taxes in four out of five of those years, and it was because of a double standard which inexplicably allows corporations, if they dole out enough stock options to insiders, to take their cost as a business expense on the income tax, escape paying U.S. taxes, but at the same time not showing that expense on their financial statements.

The sums here are huge. Just to give you one example, AOL Time-Warner apparently has stock option deductions totalling $10 billion that they will now be using to shelter corporate income taxes for the next 20 years. That is the expectation, no taxes from AOL Time-Warner for the next 20 years because the have given out $11 billion in stock options.

Warren Buffett, CEO of Berkshire Hathaway, puts it this way. "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

The claim has been made that consistent tax and accounting treatment of options would cause companies to stop issuing stock options to average workers. But according to a Bureau of Labor Statistics study, only about 1.5 percent of non-executive employees in the United States actually receive stock options in their pay. Stock options go primarily to corporate executives.

Business leaders have denounced the stock option excesses and called for reforms. Federal Reserve Chairman Alan Greenspan recently testified that the failure to account for stock options has added 3 percentage points a year during the late 1990's to reported earnings.

What I think is really the most critical comment of Alan Greenspan, is the following. Stock options have encouraged companies to "game the accounting system." Those are his words. Stock options have encouraged companies to "game the accounting system."

Well, gaming the accounting system to make a company's balance sheet look better than it should be in terms of real income is exactly what Enron is all about. Former Federal Reserve Chairman Paul Volkers expressed similar sentiments. Warren Buffett, as I said, has called stock options "the most egregious case of let's not face up to reality behavior by executives and accountants."

Arthur Levitt, former chairman of the Securities and Exchange Commission, has condemned the hyperbole that some CEOs use to oppose stock option reform, declaring that the honest treatment of stock options will not have a significant negative impact on American corporations.

Over 80 percent of the financial analysts—80 percent—that were surveyed by the Association of Financial Analysts, called the Association of Investment Management and Research, consider stock options a compensation expense that should be reported as such on company books.

Now, perhaps most important of all, investors and their representatives are insisting that stock options be treated on the books the same way as all other forms of compensation. You will be hearing from two of them today, the Council of Institutional Investors and the CEO of TIAA–CREF, a major pension fund, and there are many others.

For instance, Bill Mann, who is the senior editor of Motley Fool. He is an investment advisor with an online column and radio program that is heard by 20 million people each month. He has been talking about stock option abuses since 1998. He testified, though, about those abuses and other problems relating to Enron before the Senate Commerce Committee last December.

He has noted that the current stock option rules hide the damage, in his words, that stock options may have caused to company earning and thereby diminished the protection to investors.

Senators McCain, Fitzgerald, Durbin, Dayton and I have introduced a bill which would put an end to the stock option double standard. We simply would require companies to be consistent. We do not say no stock options. Our bill says, treat stock options the same way on your books as you do on your income taxes.

If you want to deduct stock options from your income for tax purposes, do so on your financial statement as well. That is all we say. We do not say, again, no stock options. We do say that stock options have value, and treat them that way on your books.

So, Mr. Chairman, something is really wrong in this area. You are looking at a number of issues, I know, including this one. I commend you and the committee for doing that.

My permanent Subcommittee on Investigations has subpoenaed, and we are now interviewing members of the board of directors of the Enron Corporation to prepare for a hearing with some of those board members next month.

We will be asking some of the questions about the compensation packages that you and other committees are making inquiry about, and you are addressing a much fuller panoply of governance issues. We applaud you for that.

I think we need all the reviewing and consideration that is possible int his area, and I would, in closing, as that the column of Warren Buffett that appeared in the press and editorials from the New York Times and the Washington Post on the subject of stock options be included in the record with my entire statement.

The CHAIRMAN. Without objection.

Senator LEVIN. Thank you very much.

The CHAIRMAN. Thank you very much, Senator. Thank you very much for that very thoughtful statement.

[The prepared statement of Senator Levin along with the news articles mentioned above appear in the appendix.]

The CHAIRMAN. Senator Enzi?

STATEMENT OF HON. MIKE ENZI, A U.S. SENATOR FROM WYOMING

Senator ENZI. Thank you, Mr. Chairman and members of the committee. I appreciate this opportunity to speak about a subject of executive compensation through stock options.

In the wake of the collapse of Enron, I appreciate the concerns members have with the issues of stock options. As we all know, many of Enron's executives and employees were issued stock options.

In the months preceding the bankruptcy, executives who were aware of the true condition which the company was in exercised millions of dollars of their options. Now, thousands of Enron employees who have been kept in the dark on the company's finances are left with worthless Enron stock and shattered retirement earnings.

I appreciate the members' efforts to try to fix problems posed by Enron. In addition, though, we should not lump the dot.com companies in what happened at Enron. Congress has to react to what happened at Enron, but we have to be careful not to overreact.

While I think legislation may be an appropriate means to ensure employees are protected and prevent future Enrons, we should not do anything to hamper employees from receiving stock in their company. When properly used, stock options can be a marvelous opportunity for employees.

I understand that Federal Reserve Chairman Alan Greenspan supports the legislation Senator Levin has put forward because he believes stock options should be treated as compensation. I agree with him that stock options may at some point in the future become compensation, but we disagree on what that point is.

We must be sure that, whatever is done, employees, small business, and start-up companies are protected. I want these companies to continue to have an incentive to issue options and employees to have the opportunity to receive them.

Let me explain what I see as some of the problems with the legislation and what some of the solutions would be. First, it is important to note that the same debate over expensing stock options on company financial statements occurred a few years ago. Some of the same arguments for and against it were debated back then.

The solution was to give companies the option of listing the number of stock options issued by a company in a footnote to the financial sheets or directly on its income or financial statements as an expense. That way, investors and employees have the ability to see how much stock was outstanding before they invested in the company or exercise their stock options.

If this legislation was enacted, fewer employees would have received stock options. Instead of employees on all income levels receiving the rewards options offer, only high-level executives would reap the benefits. Regardless of what Congress does on this issue, these companies are not going to cease offering CEOs and senior executives this form of compensation. It is just not going to happen. We all agree on that.

Companies will pay whatever they have to pay in order to get the very best talent at the top levels of the company. If the options become more expensive for the company to offer, which is what the Levin legislation accomplishes, rank and file employees will lose an instrument that they utilized to develop wealth. This legislation will also have negative consequences on the small businesses and the start-up companies.

The National Commission on Entrepreneurship has reported that high-growth entrepreneurial companies create roughly two-thirds of all the jobs in the United States economy and are responsible for at least two-thirds of the innovation in the economy, and account for about two-thirds of the difference in economic growth rates among industrialized nations.

The commission has further noted that the Levin-McCain legislation will negatively affect the 30 years of favorable tax and accounting treatment afforded to stock options granted by entrepreneurial companies to their employees.

These small, start-up companies cannot afford to offer the salaries larger companies give, so they offer stock options as an incentive to attract higher-skilled employees.

The commission points out that, without stock options, household names like Intel, Federal Express, Apple, Del, and Starbucks would not exist. Under the current law, the employees that take the risk of working for start-up companies have the ability to make much more money than through the traditional method of payment by wages.

Again, most employees do not want to lose this monetary opportunity, and start-up companies certainly cannot risk losing the stock option incentive they currently have to attract employees. We all know that ingenuity and the entrepreneurial spirit have helped make this country great.

Small companies and start-up businesses have been the backbone of the economy. They have provided economic growth and employment opportunities to small- and medium-sized communities. We cannot risk discouraging this important trend by placing negative pressure on this already fragile sector of the economy.

I have a longer statement I would like to have in the record, but I would like to deviate for a moment from it. Our goal, of course, is to make sure that we compensate employees and executives.

You will recall that we passed some legislation about a year and a half ago to make sure that all employees could get options. We reduced some of the accounting requirements so that it did not make it impossible for the average employee to get it.

Now, we may not have put enough incentive in yet for that average employee to receive additional stock, but we made it possible for it to happen and it has been happening.

We want to make sure that we are retaining key people. That is especially important when there is not enough cash flow. Now, we want to encourage company and stock growth, and that relies on employees who are concerned about that. It is an incentive program. It is not a guarantee program.

The employees know that, the shareholders know that, the executives know it, and the board knows it. We need to make sure the stockholders are protected and we need to make sure that everybody is paying their taxes.

Now, this particular issue gets complicated by the number of players that there are. We have the shareholders, we have the corporate board, we have the recipients, and of course we have the IRS.

Now, the number and timing of actions involved also complicate it. There is an approval of the option shares, there is an offer to the employee which I think is called the time grant.

There is the exercise by the employee which is the first time that there is any ownership. That is based on individual employee decisions. Each employee who is awarded stock options has the choice of when to exercise that stock option. It is not a company option.

Each employee exercise definitely triggers a company expense. Each employee exercise triggers a tax for that employee on the earned income, and each employee exercise puts money into the capital account. Prior to that time, there is no gain or loss. Then, of course, there is another event that complicates it even more, and that is when the employee sells his shares.

I learned that I was going to be doing this presentation yesterday, and it was in the middle of the night when I came up with an idea for a chart.

The CHAIRMAN. Well, I have got to tell you, Senator, I am proud of you. Finally, we have a chart that is a little bit interesting. [Laughter.]

Senator ENZI. The front of that, of course, recognizes the 100th anniversary of the J.C. Penney Company, which started in Kemmerer, Wyoming. I always have to get in a little chamber of commerce stuff for Wyoming. That company would have been even more successful had stock options been invented earlier. [Laughter.] There. I tied in the other side.

But this points out some of those complexities and the number of times that things happened and where the money goes. When a company first starts, the stock is not worth anything. Later, the company may decide to do stock options. At that point, that would be the approval point of the stock. It does not really affect anybody.

Now, when it is granted, that is when the employee, whether it is an executive or one of the bottom-of-the-chart employees, actually knows that they have a possibility of some income, but they have no income yet.

Often, that grant is at or above the cost of the stock at the time that it is issued, so it may never reach the level at which a person can afford to buy it, or there would be any sense in buying it. So, the employee does not make any decisions at that point.

Eventually, hopefully the stock rises well above what the grant price was, and it has to go above that amount because there are some tax consequences to the employee at the time that it is exercised. When they exercise it, they pay the offer amount. That amount goes into the company treasury.

At first I thought that stock options diluted the ownership of all of the other employees. It does not, because there is compensation paid into the treasury equivalent to a value set by the board of directors at the time of the grant of the option.

So, the company receives compensation, but the employee receives a value above that compensation. He receives the difference between the offer price and what its true value is, and can sell it at the moment that he gets it under some circumstances.

Some companies who are looking for longevity of their employees tie the longevity of the option and the ability to cash it to the timeframe in which they can exercise it. Some of the companies are just considering it compensation.

So at this exercise point in time, of course, the taxes are paid by the employee, whether he sells them or not. Then, of course, there is a later point in time, the sale point in time.

At that point in time, they are hoping there may be even more money. There is no guarantee that the exercise level will ever go above the grant level. There is no guarantee that the sale price will stay above the exercise price, even though the employee will have paid taxes up to the amount of the exercise price.

So I am kind of excited, because I finally get to talk about something on accounting around here. I am trying to keep the dollars out of the thing. But it gives a little bit of an idea of the complexity that we are dealing with here.

But I know that we are making sure that all of the taxes get paid on the gains that are made on the stock options. There is a tremendous amount of difficulty with the company keeping track of all of the different points on the thing, and there are some ethical points in time involved in this.

I really think that the ethical points in time that we may want to concentrate on are the approval to issue at some future time for some certain amount. And of course there is some constraint on that, which would be the shareholders' willingness to buy the stock at all.

That is the disclosure of the shares that are issued. There is also an ethical point in time when it is offered to the employee. That is, who is included, and for how many options. That is a decision that the board gets to make. Also, what this cost at the time of the grant will be, whether it will be at the level of the stock value at that time or it will be some amount that is higher.

Then the time before exercising it, what kind of constraints we would put on that, and whether the company can do any re-pricing. Re-pricing enters into this.

In some instances, if a company stock stays depressed longer than they expected, the board does have some capability at the present time to re-price that stock option to make it a lower price so that the employee will be encouraged to pick up the stock option.

Then, of course, there is the ethical point in time for the company's time of expensing. One of the things we have to watch out for, is early expensing allows some manipulation of taxes and inflated expenses could encourage investors to over-invest as an indication that the company thinks that the future value will be much greater. That is why it does not show up on the financial statement.

I know it is complicated.

The CHAIRMAN. Thank you, Senator, very much for your appearing today. I got a kick out of your chart there. It is a lot different than other charts that we see, and I want to just thank you. [Laughter.] I want to thank you for the variety.

Senator ENZI. You probably do not have many that were made by Senators.

[The prepared statement of Senator Enzi appears in the appendix.]

The CHAIRMAN. I know you are both busy, unless you want to take a couple, three questions.

Senator LEVIN. Sure. Whatever you like.

The CHAIRMAN. One of the questions I have, and Senator Enzi touched on it, and that is, Congress, several years ago, did address this issue with respect to financial statement reporting.

Senator LEVIN. Financial what?

The CHAIRMAN. Financial reporting. The financials. That is, FASB was, I think, at one point considering changing its rules so that the financials, with the income tax returns, would also show. As I recall, the Congress basically told FASB not to do that.

Now, my question is, is that, in your judgment—I will talk with you, Senator Levin—a better approach, rather than requiring Congress to change the tax laws to require expensing of the options?

Senator LEVIN. Well, both approaches, it seems to me, are legitimate. There is an accounting approach, which they hopefully will adopt independently. They were put under huge pressure by executives to back off from what they wanted to do 10 years ago. The analysts, 80 percent of them, say that this is, in fact, an expense which should show up as an expense like all other forms of compensation.

An independent board, it seems to me, is likely to arrive at that conclusion, just as the International Accounting Board has apparently now done. That is one approach.

But we have the responsibility of adopting a Tax Code. If a company decides that it is not going to show compensation expense for options, it is not going to show the options it issues as a business expense on its own books, if that is the course that it chooses to take, then I do not see why we should give it an expense on the tax return. That is a double standard which makes no sense. But that is our choice. I mean, I think the accountants have responsibility. I hope they exercise it.

The CHAIRMAN. But I am asking you, what is preferable, given the two? TASCO tries to match a company's deductions to the time an employee takes the amounts into income.

The question I have is whether the Tax Code is the proper vehicle to address this question. Rather, to the degree that it is a problem, should the question not be addressed as an accounting matter? That is, frankly, what we are talking about here.

Senator LEVIN. I do not think we can duck our responsibility. We write the Tax Code. We say, if you get a performance-based bonus, for instance, that is shown on the company's books as an expense.

If a company gives out stock, the value of that compensation will go up if the stock value goes up, but the value of the stock when it is given must show as a form of compensation on the books.

The CHAIRMAN. I know. Again, I am asking the question, is this more of an accounting question or is this more of a tax question?

Senator LEVIN. It is both. We have adopted a Tax Code, so it is both. We cannot duck it by saying it is an accounting problem. We have adopted a Tax Code which says that you are going to be given a deduction. We made that decision.

We said to companies, you get a tax deduction as a business expense. That is our decision. Even though you do not show it as an expense on you own books. That is our decision. We cannot just simply say that that is an accounting issue. It is both.

The CHAIRMAN. Let me ask Senator Enzi his response to that question.

Senator ENZI. From a tax issue, it is very important that we make sure that all of the taxes are paid. I am confident that we are making sure that all of the taxes are being paid.

From an accounting standpoint, I think it is very important that that be addressed by the accounting standards. Of course, I am hoping that there will be some changes in the accounting standards.

I would like to see us go to a principle-based accounting standard. That is being suggested by the head accountant to the SEC, as well. I think that FASB is even looking at going that direction. That will make some quicker decisions and will address the accounting aspects of it in a very positive way.

The CHAIRMAN. Well, thank you. This is a central, core question here. I appreciate your response.

Senator LEVIN. Can I just comment on that, that all the tax is being paid?

The CHAIRMAN. Sure.

Senator LEVIN. Enron did not pay taxes four out of the last 5 years. AOL Time-Warner will never pay taxes under the current system because of stock options which they have granted which do not show as expenses on their books.

We, nonetheless, under our current Tax Code, give them a tax deduction. So, all the taxes are not being paid the way they are on all other forms of compensation which are treated as an expense on the books in order to get a tax deduction.

We say, hey, you can get a tax deduction here even though you do not show it as an expense. You do not treat it as an expense; we are going to give you a tax deduction anyway. That is not paying taxes. That is a double standard.

Senator ENZI. Actually, under an accounting situation, what we would be doing is raising taxes on the company if we went with the approach that is proposed in the legislation.

The CHAIRMAN. Well, we have not yet resolved this issue.

Senator Grassley?

Senator GRASSLEY. I will defer to Senator Gramm because he has to go.

Senator GRAMM. Mr. Chairman, I will be brief. I have got to go.

I think, first of all, what we are saying here is an assault on stock options as if incentives created the Enron problem. I guess I go back to the old adage that we all know from the law, and that is, bad cases make bad law.

I personally think stock options are good things. Anybody who has ever tried to undertake any kind of activity with other people understands putting them in a position where they share your incentives. I think that this whole tirade against stock options is not well-founded, in my opinion. I think it is not our business to dictate how private companies compensate their employees.

I think, second—and you raised the question, Mr. Chairman—let me say that I think trying to dictate the accounting standards through the Tax Code is profoundly wrong.

I think there are many cases where you, for the purposes of paying income taxes, figure your income taxes on one basis, and in terms of setting out the well-being of your company and looking at its future, might present it in a very different way.

I have looked at this. I am on the Banking Committee and we have jurisdiction over accounting standards. When this whole debate occurred in FASB about how to treat stock options—and I always took the position, I may or may not agree with FASB, but I do not think Congress ought to be setting accounting standards. I think it is a very dangerous policy.

But in any case, I guess where I come down on this, and I differ a little bit from Mike, and that is, I would say that to the extent that the sale price exceeds the offer price, that that is a dilution of ownership.

But I do not see how, under any circumstances, you can present it as being a reduction in earnings. I mean, I think you are getting a totally distorted view of what is happening in a company.

If Mike and I owned a company together and the value of our stock was $1,000, and we wanted somebody start to run it and we hired Carl, and we gave him stock options that ended up being worth $500 and we had a great year and we earned $500, does it really reflect the future prospects of our company to report that we had no earnings?

What we have done, is we have committed to share current and future earnings with Carl on the basis of this grant of the stock. So, I agree that we need a way to reflect the impact of stock options on companies that is better than what we have now, which is primarily reporting in the stockholders' report that you granted these options.

I personally believe that we need a way of reporting dilution of ownership, but understanding that accounting is really trying to come up with a simplified picture of reality so people can know what is happening at its best, anyway, I just cannot for the life of me see how charging for the purpose of giving a picture of how well your company is doing—I just see these options as a dilution of ownership, but I do not see them in terms of looking at the health of the company.

I do not think we make that view clearer by forcing them to be charged against current earnings. I guess that is where I come down on it, Carl. I think these are complicated issues. I think debating them is good.

When we get to the end of the day, do we want to legislate accounting standards or do we want to set up a board with some degree of independence to make these decisions? We decided not to vote on monetary policy and we set up the Federal Reserve.

Mike, I think, is the only CPA in the Senate. I did take two accounting courses, but when we got to the practice set in the second one I decided accounting was not for me.

But it just frightens me, if we are going to start setting accounting standards. I think having some degree of reservation about doing that is probably healthy.

Mr. Chairman, thank you.

The CHAIRMAN. Thank you, Senator.

Senator Thomas?

Senator THOMAS. Thank you, Mr. Chairman.

I think options should be available. I do not think we should try to manage companies. I think there ought to be transparency if there is value. I think when they go out, if there is a value, there is a value, and that is an expense. Otherwise, there is a profit. I think the taxing question is probably our most important one.

Thank you.

The CHAIRMAN. Thank you.

Thank you both very much. We appreciate it.

Senator LEVIN. Thank you very much, Mr. Chairman.

Senator ENZI. Thank you.

The CHAIRMAN. All right. Now we will hear from our panels.

Our first witness is Dr. Carolyn Brancato, director of the Global Corporate Governance Research Center at The Conference Board in New York; Sarah Teslik, executive director, Council of Institutional Investors, Washington, DC; Robert Pozen, professor at Harvard University, formerly vice chairman of Fidelity Investments, and president of Fidelity Management and Research Company at Cambridge, Massachusetts.

Thank you, all three of you, very, very much. I am sure you found the discussion we just had a little interesting. You will be able to shed some light on it.

Dr. Brancato, why do you not begin? We have a 5-minute rule here, which we did not honor in the last session. We will try to honor it a little bit more this time around, so try to keep your statements within 5 minutes, if you can. Your full statements will be included in the record.

Why do you not proceed, Dr. Brancato?

STATEMENT OF DR. CAROLYN BRANCATO, DIRECTOR, GLOBAL CORPORATE GOVERNANCE RESEARCH CENTER AT THE CONFERENCE BOARD, NEW YORK, NY

Dr. BRANCATO. Thank you, Senator. It is a pleasure to be back on Capitol Hill after having been an alumni of the Congressional Research Service. I am now with The Conference Board. We are a non-advocacy organization, business membership organization. We have more than 3,000 corporations in more than 62 countries of the world. We are devoted to sharing best practices.

Our Global Corporate Governance Research Center is a branch of the conference board. To ensure objectivity, we have members from both the institutional investor community as well as the corporate community.

We focus on best practices in corporate governance and analyze these around the world. We find that there is no one U.S. model of corporate governance. We find that within the United States there are a variety of models of corporate governance ranging from companies with widely dispersed shareholder base, companies with closely held blocks of investors, and the corporate governance will basically reflect more on the ownership structure of the company rather than its location.

So, a dot.com company in the United States might actually look very much like what we think of as an Asian model of corporate governance, with a small, closely-held group.

We do find that there is some convergence in corporate governance standards around the world, with the focus on increasing director independence, accountability to shareholders, increased transparency and disclosure, and protection of minority shareholder rights.

One of the focuses that The Conference Board has is on the aftermath of Enron. We believe that Enron will create a seed change in corporate governance, both in the United States and abroad, as companies begin to focus much more on their internal governance processes rather than on corporate governance that is legislated, or regulatory, or imposed from without by the courts, the regulators, and in some cases the legislative branch.

So we believe that Enron will really result in a lot of internal debate within corporations to find out how they can best manage their boards. Boards around the country are devoting a great deal of time to looking at their internal corporate governance processes.

We are engaging in a major research project at The Conference Board with senior executive and roundtable projects in meetings around the country to be held in places like Stanford Law and the University of Delaware, with input from the Delaware courts.

We will be focusing on what red flags directors can and should be more aware of to prevent an Enron from occurring in the future, and how do boards fulfill their monitoring responsibilities, yet how can they rely on management and consultants such as accountants and compensation consultants?

My testimony considers a number of issues, such as the duty of care and duty of loyalty, which I will not dwell on. But I want to highlight just two things that we are focusing on in our research.

The thrust of our research is to look at effective board practices to find out how the board can manage itself professionally and bring professionalization to the board in a much greater degree than it has in the past.

One of the key elements that the board must do, is look at oversight of management performance. One of the areas that we have done a great deal of research on at The Conference Board is on what we call a dashboard of corporate performance, where, instead of looking at last quarter's earnings which are much like looking in the rear view mirror of a car, you look at dashboard indicators that will enable you to get your company where it want to go to reach its destination.

For example, quality indicators, indicators such as environmental compliance. These dashboard indicators are detailed in the Appendix 3 of my report, and also can be linked to compensation in ways that alleviate some of the problems of stock options which only relate to stock price, whereas strategic performance measures such as quality can be used as part of a compensation package.

Chrysler was one of the earliest companies to use and compensate executives for quality improvements as measured by warranty data.

So we suggest that in the debate over compensation, that the professionalization of the board of directors be considered as well as new methods of compensation.

Thank you.

The CHAIRMAN. Do you have more?

Dr. BRANCATO. I have a great deal more. [Laughter.]

The CHAIRMAN. Do you have anything more than you very much want to succinctly say?

Dr. BRANCATO. Well, The Conference Board has some research in which we have tried to look at 10 key elements in which a board may ask itself questions to see if it is professionally run. Those 10 elements are in my testimony.

They do include finding out whether or not the audit committee is run professionally, whether or not the board members that are members of the audit committee unduly rely on external accountants, whether or not, for example, you have accountants that function both for the external audit and the internal audit function. That is a red flag, as far as we see, with respect to best practices.

So there are a series of red flags that a board should be able to find out with respect to management as well as the control of any outside consultant. We have a book on the compensation committee of the board in which we have written and basically outlined some of the ways in which the compensation committee can professionalize itself more, get control over those compensation consultants, and take more control over the process.

The CHAIRMAN. Thank you very much.

Dr. BRANCATO. Thank you.

[The prepared statement of Dr. Brancato appears in the appendix.]

The CHAIRMAN. Ms. Teslik?

STATEMENT OF SARAH TESLIK, EXECUTIVE DIRECTOR, COUNCIL OF INSTITUTIONAL INVESTORS, WASHINGTON, DC

Ms. TESLIK. Thank you very much.

A reporter asked me the other day whether there was more corporate and accounting fraud than there used to be, and I answered that there was. There is data to back that up.

He asked, why? I said it was not because human nature has changed, because you can bank on the fact that human nature is, everywhere and always, the same. I think that there is more corporate accounting and financial services fraud today than there used to be because it pays. There are, in fact, immense up-sides to engaging in this kind of behavior, and frankly very few down-sides.

Now, the next question ought to be then, how have things changed? If there is more now than there used to be, how is our system different than it was 30, 40 years ago?

I think the fair answer to that, is three parts. One, the laws that we put in place after the Great Depression to protect investors have gradually over the decades been worn down by special interests.

Special interests approach you, they approach the SEC, they approach other regulatory bodies. But the average American cannot, and does not. So, given enough decades, those laws have been worn down like stones in a creek.

Second, the people interested in getting around the laws have gotten better at finding loopholes. Fifty years of finding loopholes is a good, long time and there are a lot of loopholes around. As you know, one of the most shocking things about Enron is not what was done that was illegal, but how much that was done that was legal.

Third, prosecutions, unfortunately, focus on companies and not on individuals. I have never heard anyone give a reason for that. It makes absolutely no sense. Companies cannot commit crimes, people can.

Suing a company instead of a wrongdoer does not deter. It only hurts innocent victims like employees and shareholders like us who are already victimized by the stock price tanking.

So the fact is, crime is a good bet, a very good bet, indeed. The cumulative effect of this wearing down is that our safety nets are failing us. The safety nets are the board of directors, the accountants, the rating agencies, the analysts, the SEC, the prosecutors.

But actually the ultimate safety net is the investors, the shareholders that I represent. We own companies. We do not want to lose our companies. We do not want to be defrauded or fleeced.

As you know if you own a car, you are apt to take care of it and you are apt to prevent yourself from being fleeced by an auto mechanic. We, too, would do that in Enrons and Global Crossings if we could. The fact is, we cannot.

I have submitted to you in my written remarks a one-page summary of how the laws have changed over the last 50, 60 years to effectively prevent shareholders from protecting their interests as owners in large publicly traded companies. If you think I exaggerate, read the list.

But I think for purposes of this committee, the key variable to focus on is executive compensation. You are correct to focus on this, because executive compensation is an enabler to corporate fraud, a critical enabler. It is also a critical diagnostic tool.

If you step back for a minute and think about it, if one person owned Enron, Global Crossing, some of these other companies where we have had executive compensation abuse, they would never pay someone hundreds of millions of dollars to fail. They would never pay someone hundreds of millions of dollars to leave rather than to work. They would never pay someone hundreds of millions of dollars to commit fraud.

When you see a compensation decision that would not have been made if one person owned the company, you know that something is up. So, executive compensation is a good diagnostic tool.

For purposes of this committee, I think the more important fact to remember is that executive compensation is, in fact, a critical tool for corporate fraud.

That is not to say that executive compensation is a bad thing. I am an executive and I like being paid. We like executives to be paid. We like them to be paid well if they do well. After all, we are America's shareholders and we do not serve on the boards, so we cannot be watching them every day. So, we do, in fact, like to see pay for performance.

But stock options are like a dangerous drug. They can be used to cure, but they can become addictive and they can be very harmful.

Without stock options, it is not possible, in companies like Enron and Global Crossing to turn the companies into ponzi schemes. You cannot do it without stock options. Not because stock options are bad, but because they operate differently than cash or bonuses. So they are a useful tool, but they are a dangerous tool.

Therefore, I think you need to have three important checks on the system. One, we need disclosure of all stock option plans. That has not been the case. It is absurd that it is not the case.

If we are paying executives with our money via dilution, we need to know what we are paying. The company knows what you are being paid. We need to know what we pay our employees. The SEC is taking steps in that direction. We will have to see if they are complete.

The other two, are we need a vote on all stock option plans. The check on the system that exists through the board of directors is not adequate with stock options. Stock options, because they are like printing up money, are more easily abused than corporate cash, where at least the cash has to be in the treasury before you pay it out. Stock options dilute future shareholders who are not even around at the time the options are granted, so it is extremely tempting to abuse them. We need to vote on them.

The third thing we need, is to see them charged to earnings. That is not because it is a simple question. It is actually an awkward fit, as Senator Gramm was saying, because there is a transfer of value.

There is no question that stock options have value. There is a value transfer from shareholders to executives, or whoever gets the options. It does not come through the corporate treasury, but it is a substitute for pay that otherwise would.

So to reflect it as a charge, you are saying, if we did not transfer the value from shareholders directly to executives, we would be transferring it from the company. So, we are reflecting it there because ultimately it does come out of the shareholders' pockets.

I think most of the arguments you hear against charging are as close as you get to humor in the accounting world: if options do not have value, why is everyone lobbying you so hard? They are acting like cocaine addicts, afraid of losing a fix.

Options cannot be estimated. They can estimate them for the Tax Code, they can estimate them for charging.

Executives will not work without options, then you have executives with an attitude problem. I work without options, you work without options. People throughout American history and around the world work without options. Owner/entrepreneurs work without options. They will be motivated.

Options being charged will cause a market collapse. This is an accounting issue. It is what you put on paper, it is not what happens in the real world. If that is the greatest worry, we need to give some coaching and stress management.

I think that the real issue here is not an issue of substance. Stock option charging is a relatively simple question, but I think the problem here is like ethical questions. It is not that we do not know the right answer, it is that we do and we wish we did not.

I think the real question here is going to be whether the members of this committee—and I thank you for holding this hearing—and whether everyone else in Congress will have the profile and courage that I admit it will take to address an issue like this and come out the right way.

Thank you.

The CHAIRMAN. Thank you, Ms. Teslik, very much. Thank you very much.

[The prepared statement of Ms. Teslik appears in the appendix.]

The CHAIRMAN. Mr. Pozen?

STATEMENT OF ROBERT POZEN, PROFESSOR AT HARVARD UNIVERSITY AND FORMERLY VICE CHAIRMAN OF FIDELITY INVESTMENTS AND PRESIDENT OF FIDELITY MANAGEMENT AND RESEARCH COMPANY, CAMBRIDGE, MA

Professor POZEN. Thank you for asking me to testify today. As you said, I am currently teaching at Harvard University. I retired in January as vice chairman of Fidelity Investments.

I realize that the committee will be looking at a large number of issues in corporate governance, and I would like to concentrate on three where I would put forward some practical suggestions that might be useful to the committee.

The three are: trying to increase the oversight of the audit process; second, this whole issue of shareholder approval of stock option plans; and third, enhancing the effectiveness of analysts.

On the first one, in terms of oversight of auditors, I think the key to having good oversight of auditors is to give the audit committee more knowledge and more power about what is going on in the audit process.

The only way I know to do that is every 5 to 7 years, for the audit committee to publish an RFP, a request for proposal, and take bids from audit firms in terms of who is going to be the auditor.

That will then make the auditors feel that they are working for the audit committee and not management, which they do not now. In most cases, the directors on the audit committee were not even directors of the company at the time the auditors were appointed.

Also, an ancillary benefit is that you would get more audit firms. Right now, we only have five audit firms because it is almost impossible to break into the business. If you have bidding every few years, you would start to get more audit firms.

Most importantly, if the old auditor knows that somebody is going to come in after a few years with the time, effort, and resources to look at all of the audit issues, that provides the audit committee with some real feedback.

I know that there is a proposal in the House, it may even turn into legislation, to have an NASD for auditors. I happen to think that this proposal is a weak idea. I have had a lot of experience with the NASD for broker/dealers and it works well mainly because it is very narrowly focused.

It is focused on the U.S. broker/deal subsidiary of a large company. It is one thing to send in an inspector, probably somebody in their 30's who is not that expert, and look at the U.S. broker/dealer subsidiary of Citigroup.

It is a very different thing to ask somebody to come in and look at the global operations of Citigroup in every single business. I maintain that the chances of such a person really understanding all the audit issues is very low.

By contrast, if you have a new audit firm come in every 5 or 7 years, I can assure you they will figure out everything that has happened. They will want to clean the books. They will tell the audit committee what is really happening. That is a much more effective system.

So I think that if we are serious about helping the audit committee, that is what we should do. We are kidding ourselves to think that the NASD model, which works in a very narrow context, could work in a much broader context.

The second area involves shareholder approval. I think, as Sarah correctly says, this is an important area. The key to stock options is how they are designed. Stock options can be designed in ways that really help align the interests of management with shareholders or they can be designed poorly.

Institutional investors are very concerned about how they are designed. When people put out proxy statements with stock option plans, they are looked at very closely for design issues.

For instance, if there is no minimum holding period, if an executive can get a stock option and 3 days later exercise it and make a big profit, that does not make any sense.

Similarly, if you can have repricing of options without extraordinary events for existing officers, that is also not a good design.

So the question is, how do we assure that there is better design? The best way is to make sure that all stock option plans contain some minimum guidelines and that they are put to a vote to shareholders. I can assure you those plans are looked at very carefully by institutions.

Historically, a Federal requirement for shareholder approval was put into an obscure set of rules called the 16(b) rules by the SEC in the Securities Exchange Act. That happened many years ago. Those rules were very complex and arcane, and the SEC properly simplified them 2 or 3 years ago.

Unfortunately, in the process of simplifying them, the SEC took out this requirement. So now there is absolutely no Federal requirement, except for the tax rules on performance compensation, for shareholder approval.

It is all left now to the listing standards of the New York Stock Exchange. There has been a lot of discussion among people in the New York Stock Exchange about what they should do.

Personally, I believe it is unfair to ask the New York Stock Exchange to be the spearhead on this because they have a competitive situation vis-́a-vis Nasdaq. They are saying, if we impose these strict requirements and Nasdaq does not, then we are in an adverse competitive position.

It is very difficult to get all these market places to agree on governance issues because they are competing for order flow. The only way that I know to solve this problem is very simple. The SEC ought to reinstitute its historic condition as part of its 16(b) rules.

The third point I want to talk about, is analysts. Buy side analysts are your best friends in terms of figuring out what is really going on with a company. They have every incentive to figure out if a company has bad accounting, if a company is under valued, and to do something about it, sell the stock or put pressure on management.

Unfortunately, the SEC's regulation FD, the fair disclosure, makes it difficult for an analyst to do a really good job on accounting issues.

Now, there are a lot of good things about FD. It is supposed to, and it does, prevent a CEO from selectively giving earnings estimates and information about mergers to their favorite analyst or favorite friend.

But the SEC never defined the term "materiality." So what happens now is you have these unworkable quarterly earnings calls. Go on the Microsoft quarterly earnings calls. There are about 600 or 700 people on the call and nothing essentially gets discussed. It is heavily scripted by the investor relations person and a lawyer, and nothing can really be understood as meaningful analysis in that call.

Now, if the analyst calls up the CFO afterwards and says, what about this accounting issue? What about this footnote on your statement? The CFO says, I am worried that this is going to be a material answer. If I give you a material answer, I am going to have to publish it to the whole world, so I am not going to do that. We see this response all the time.

The solution to this problem is to realize that materiality is very different for the normal investor than for the expert analyst. What we ought to say is companies should not be able to selectively disclose information that is truly market moving for the ordinary retail investor, which would include items like mergers, earning estimates, and these sorts of things.

But, on the other hand, if you are going to say, is this significant to an analyst? If an analyst is a really good accounting expert, everything is significant to the analyst. We want that analyst to understand as much as possible about the accounting statements. We want to give them the incentive to do that.

If they then ask a technical question and they get an answer which is significant to them only because they have done all this brilliant analysis and put together all this stuff, they should be rewarded for the effort. They should not be penalized.

So I think the time has come to have the SEC revisit regulation FD and come up with a much more precise definition of materiality that will encourage the sort of analyst behavior that I think we want in accounting issues.

Thank you very much.

[The prepared statement of Professor Pozen appears in the appendix.]

The CHAIRMAN. Well, thank you all very much. This has been very helpful.

A basic question. I have lots of questions. One hears that boards are often co-opted by management, that there are not enough independent directors. You touched on it a bit, Mr. Pozen. That is, the audit committee or the compensation committee really is very closely tied to management and is not terribly independent.

Let us take a board audit committee. They meet quarterly, maybe only for a few days. How in the world are they going to know what the true financial picture of the company is? Mr. Pozen suggested changing auditors. I guess basically the auditing committee, essentially, is outside directors.

Professor POZEN. If you have an audit committee of outside directors and they are the ones who hire the auditors on a periodic basis and set the terms and conditions of the auditors' compensation, then the auditors will start working for the audit committee and they will provide the audit committee with the type of information that they need.

Right now, the audit firms view themselves as working for management and it is extremely difficult to get them to tell the audit committee exactly what are the complex and difficult issues they are facing.

The CHAIRMAN. Would either of you, Ms. Teslik or Dr. Brancato, like to comment on that?

Dr. BRANCATO. I think one of the areas, as well, we would agree that that is one of the best practice policies that is being discussed. Also, to look at the alumni auditors and their relationship to the firm, to the corporation itself. There sometimes is a bit of a revolving door between people from the audit firm and the lead partner, and so on. I think those should be looked at as well.

Obviously, if you are a listed company you have to have three independent directors on your audit committee. But the definition of "independence" by the New York Stock Exchange, while it is detailed, does not really get to the heart of the matter. You can have people who are, on paper, independent, but they may not be acting independently. They may not be asking the hard questions. I think that is an area to look at.

I would also just comment on the rotation issue of auditors, to have the audit committee as well as the compensation committee also consider rotation of external consultants for the purpose of knowing whether or not the board is actually controlling those consultants. Whether they are accountants or compensation consultants, the principle of rotation may also apply.

The CHAIRMAN. Ms. Teslik, do you have a comment?

Ms. TESLIK. Yes. I think it is correct that the definition of independence used by the NYSE and other entities probably does not get at true independence. That is probably less important than the debate suggests because, as long as management selects the directors, you can define independence until the cows come home and management is still the one that selects the directors, so there is going to be a tie there.

However, I think for the question you asked, the concern about the lack of independence is reduced because directors do care about their reputation. They do not want to be in the position of the Enron directors. By and large, it is not the directors who say, let us commit fraud. It is more that it would be coming from management.

So if you arrange for the audit committee of the board to hire and fire the auditors, I think you increase substantially the chance that audit firms will be comfortable in saying, I have been asked to do something that I am not comfortable with, and by the way, your reputation may tank if we do it. So, I think that is a very good thing.

The CHAIRMAN. I have never served on a board, so I do not have any direct experience in these matters. But one question in my mind, is how does one ensure the independence of the audit committee if one wants to ensure the independence of the audit committee?

I just wondered if the auditor who works for the audit committee was also talking to the other board members and the management. I do not know. I was just curious if that is a real distinction or not.

Ms. TESLIK. I think, by and large, relying on independent committees is more of a sham than we think, because in many cases, even if your definition of independence is real and even if everyone meets it, the CEO or the CFO sits in on all the meetings. So, what difference does it make? I mean, management is present. However, if, in the auditing case, the audit committee takes the bids and it routinely meets in executive session without managers present, that is a significant step.

Professor POZEN. I would say that most independent directors try to do a good job. But most of them do not have the time or the expertise to really do the job well. They want to do a good job.

I think the one of the two things that are being discussed here is to have an audit committee composed entirely of independent directors who actually hire the auditor, set it terms, et cetera, and second of all, that they should be able to have executive sessions with the auditors without anyone from management present.

The CHAIRMAN. How do you ensure that?

Ms. TESLIK. Listing standard.

Professor POZEN. You can put these in the listing standards. The SEC could include these as part of its exemptive rules. There are a lot of ways to do that.

Those are probably the two procedures that will get you most toward where you want to be, though ultimately it depends on the quality and the diligence of the independent directors. But, as a matter of process, those two things would put us in a much stronger position.

The CHAIRMAN. All right.

What about the shareholders? You said, Ms. Teslik, when people buy a new car they take care of it. Most people do, if you want it to last. The same with shareholders. They buy stock, they want to protect their investment. It is often said that the small investor, individual investor really has no idea what is going on. the institutional investors may to some degree, but even they may not know as much as one would assume or infer them to know.

If shareholders are required to approve, say, stock option plans, what guarantee is there that the shareholders will know what they are voting on? This stuff can get pretty complex and pretty arcane.

Professor POZEN. First of all, most institutional investors do represent the small guy. For example, Fidelity's funds represent 12 million small guys. The TIAA–CREF pension fund represents millions of small guys.

Second of all, I think we have to rely on institutional investors to be the vetters of these stock option plans, and they do. Every single institutional investor has a set of guidelines on how they evaluate stock option plans, in which they say here are good design issues and here are not-so-good design issues. Design issues are looked at. There are lots of institutional investors who have discussions with management about trying to improve the design of those programs.

It is reasonable to think that the institutional investors should be the leading group in this area. Remember, institutions own roughly, depending on the company, 40 to 60 percent of the company stock, and that they constitute a much higher percentage of the voting holders on the stock because they tend to vote their stock.

I do not think it is realistic to have the little person who owns 100 shares of a large, complex company to review option plans. But I do think that we do have a mechanism by which we can bring to bear a lot of expertise representing a lot of small guys to go through these option plans and analyze them.

The CHAIRMAN. My time has way expired. I apologize to my colleague from Arkansas.

But one quick question here. Is there a difference among institutional investors on this point? That is, between, say, a CALPERS or public pension fund versus, say, Fidelity or some others?

Professor POZEN. There are lots of differences between institutional investors. Some are more active, some are less. Some have active approaches to investing, others have mainly indexing.

But on this issue of voting on stock option plans, I think you would see that most institutional investors diligently look at those stock option plans. So, that is not an area of difference. Some people may have different guidelines.

The CHAIRMAN. Do you agree, Ms. Teslik?

Ms. TESLIK. Our members voted unanimously to support voting on all stock option plans and they voted with only two "no" votes to support charging them to earnings. That is pretty overwhelming.

The CHAIRMAN. All right. Thank you.

Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman. Thank you so much for having this hearing. There are so many issues that need to be addressed in the area of executive compensation.

As you know, I had some concerns in a previous hearing regarding some of Enron's executives and their use of split-dollar life insurance arrangements. I have tried to learn as much as I can about the pros and cons in that issue and still seem to have some questions. I want to say thank you to you.

I know you and your staff, as well as Senator Grassley, had worked hard to gather a good panel and had arranged for a particular individual to be here who could describe to the committee the complexities and the tax issues involved with the split-dollar life insurance arrangement.

I am not completely sure of the circumstances, whether that individual is still here or if they are going to be. But I hope that if they are absent, that in the future, as the Treasury Department considers some of the regulations in that area, that you might consider holding maybe another public hearing, forum, or some type of discussion, perhaps with a variety of the administration officials to consider the policy goals of those regulations and their potential practical effects, and whether legislation should be considered or not.

So I hope that maybe, without being able to ask that question of that panelist, I hope that we will think about that further.

The CHAIRMAN. Absolutely. Absolutely, Senator. I deeply regret that the witness we wanted to appear before us today was unable to appear. That is an issue that is very important and we will dig into it deeply. I assure the Senator that certainly it is an issue on my mind that I want to resolve, and we will have an appropriate way to resolve that.

Senator LINCOLN. Right. Well, I thank you, Mr. Chairman. You and Senator Grassley have certainly worked hard at that, in getting someone here, and I appreciate your efforts there. We will look forward to answering some of those further questions down the road.

I would like to thank this panel that is here. Ms. Teslik, you mentioned in your statement that placing value on non-vested stock options actually does exist. Whether it is for corporate reorganization or for estate tax purposes, that corporations will, for their own in-house, I suppose, tax purposes, assign a current value to those non-vested stock options.

Are there any other circumstances that they would do that for?

Ms. TESLIK. Beats me. I do not know whether there will be other situations where they estimate the value. Obviously, they do for a tax deduction purpose. The point is, they can be valued with enough accuracy for these purposes.

Senator LINCOLN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Your preference, the three of you, on the options issue and the degree to which it should be addressed. Should it be through the Code or should it be through changes in accounting?

Professor POZEN. Can I just say something? I am not going to try to resolve this major debate, but I do think that there is one striking anomaly here that relates to this issue of design. That is, there is only one type of option which you are required to expense now under current rules. That is an option that has a price that varies in relation to an index; it is sometimes called a variable price option.

With any type of fixed price option where you just say, today the stock is at 20, so you will make the option price 20, you do not have to expense. But you do not have to expense if you are in the semiconductor industry, and what you say is that the exercise price of the option will be set relative to how well the semiconductor index does.

Essentially, you have to do, over a few years, better than other semiconductor companies or you have to do better than the S&P 500. That is the only type of option that needs to be expensed now. I would argue, from a design point of view, it is often one of the best designs to assure that there is this alignment between management and stockholders.

So whatever way that debate comes out, and I cannot resolve it for you, I think that it is a bad practice to have a particular type of option which is often well-designed (though there may be issues in choosing an index) be the only one that has this stigma attached to it of being expensed on the income statement, and we should change that.

The CHAIRMAN. Should the change be in the Code or should it be in the accounting standards?

Professor POZEN. I personally think the first thing that ought to happen is the accounting standards ought to be changed. I think that is something that this is an anomaly in the current accounting standards.

I cannot quite understand why that would be true, even under the current reasoning of the accounting standards. It is an accounting anomaly.

It tends to make it impossible for a board that wants to have this type of option, which might very well be well-designed. It makes it very difficult for them to use it, because people say, why should we use this type of option when it is the only type of option that is expensed? I think it could be done by the accounting board.

The CHAIRMAN. Dr. Brancato?

Dr. BRANCATO. That type of option is widely used in the U.K., actually. I believe—correct me if I am wrong—that came out of the Greenbury code, the Cadbury/Greenbury codes of corporate governance and it is widely used in the U.K.

The CHAIRMAN. Ms. Teslik?

Ms. TESLIK. I think that most of our members, if they knew that they would get it for sure, would prefer it through the FASB. I do not think they would like, otherwise, to give up on going for both options because the chance of getting either is so small.

The CHAIRMAN. All right. I have got a lot more questions, but do not have a lot more time. Thank you very, very much. This is obviously an issue we are going to be involved with for a considerable period of time. But thank you for taking the time to come visit us.

Our next panel consists of Dr. Ira T. Kay, vice president and U.S. practice director for executive compensation, Watson Wyatt Worldwide, New York, New York; Kathryn Kennedy, assistant professor of law at the John Marshall Law School, director of the Center for Tax Law and Employee Benefits, Chicago, Illinois; John H. Biggs, chairman, president, and chief executive officer for TIAA–CREF, New York, New York; and Mark Heesen, president, National Venture Capital Association, Arlington, Virginia.

This panel, as I have indicated, is focused primarily on executive compensation. All of you have heard the prior testimony. If you have comments on something that has been said before, I urge you to do so.

But why do you not begin, Dr. Kay, with your testimony? And your statements will automatically be included in the record.

STATEMENT OF IRA T. KAY, PH.D., VICE PRESIDENT AND U.S. PRACTICE DIRECTOR FOR EXECUTIVE COMPENSATION, WATSON WYATT WORLDWIDE, NEW YORK, NY

Dr. KAY. Good morning, and thank you for having me.

Executive pay practices have been controversial in the United States for the past 15 years. In the late 1980's and early 1990's, critics argued that there was not enough pay for performance, that executives did not have their pay linked to the performance of their company stock.

Over the past years, there has been a tremendous increase in the amount of executive pay, 15 percent to 20 percent annual compound growth rates at the typical $1 billion in sales company. Most of that increase has been in the form of stock options.

What has not been mentioned thus far, fascinatingly, is during that time the performance of many American companies in the U.S. economy has been spectacular. Whether that performance is a coincidence with the rise of stock-based incentives or whether this type of executive pay played a significant role in causing that superior performance has been hotly debated.

Despite the high-profile examples of extremely high pay for performance that the media has been highlighting over the last few weeks, I believe that these pay practices were an important component in creating the successful U.S. economic model.

As discussed by others, executive pay is controversial for a number of reasons: the $100 million stock option plans, the high pay for poor performance, and so on. It is no wonder this area is so hotly criticized.

However, I believe that it is essential to take a hard, objective look at the data. It is well researched by academics. Watson Wyatt, my own firm, has also done numerous studies looking at these questions, and others. Most importantly, I believe that shareholders, the final arbiters of this controversy, need to look at the typical individual company and not the most egregious examples.

In this spirit, I present the following list of myths and realities of executive pay. Number one, CEOs of billion dollar companies are well-paid by the standard of regular employees. This is reality.

The typical CEO of the largest 1,200 companies in our study had salary, bonus, plus stock options exercised of more than $1.3 million. Yes, there are those $100 million paychecks, more than seven of them in 2001.

However, relative to the enormous economic value created by these executives, they appear to be worth the expense and they look even better in comparison to lower-paid Japanese CEOs who run troubled companies.

In addition, I am reminded of Senator Levin's chart which he showed at the 1992 hearings which I testified at, the big question on that is, is that demoralizing to employees and is that reducing their productivity?

Our research shows that it is not. As long as the employees feel that they have the ability to share in the up-side that those CEOs are generating, they are very excited about those companies.

Number two. There is no pay for performance for executives. All CEOs become rich on their stock options. This is a myth. Watson Wyatt and much academic research show two important findings. A, the highest-paid CEOs work for the highest-performing companies, the lowest-paid CEOs work for the lowest-performing companies.

B, executive pay levels at most companies go up and down with the performance of their company in a given year. We have looked at data for the last 3 years, two changes, 1999 to 2000, and 2000 to 2001.

In the first set, for the 1,200 companies, pay went down for those CEOs by 30 percent from 1999 to 2000, with nearly 75 percent of the CEOs experiencing a decline. For a smaller sample of companies in 2000, 50 percent of the companies went down with an average net decline of 1 percent. Are there examples where pay goes up while profit goes down? Yes. But these are more the exception than the rule.

Number three. Are there companies who have stock option levels beyond a comfort zone for shareholders and who are not receiving an adequate return on that investment? This is a reality.

Our research and academic studies have shown that companies with excessively large amounts of stock option overhang, as it is technically called, have lower returns to shareholders.

Number four. Stock options perfectly align the interests of executives with those of outside shareholders. This is partly myth. Stock options have no down-side risk and they are an imperfect substitute for real share ownership by employees.

Number five. Executive stock ownership is very helpful to companies. This is a reality. Research has shown that companies with significantly large amounts of executive stock ownership perform better than companies with low executive stock ownership.

Number six. The labor market for executives is a rigged labor market, where the CEO stacks the board with his or her friends and they in turn set pay at as high of levels as possible. The compensation committee is comprised mostly of insiders who do whatever the CEO wants them to do. These board members spend their time approving egregious compensation programs that are not approved by shareholders. This is all myth.

The CEO labor market meets all the criteria of any market, including independent supply and demand, transparency, and liquidity. I attend three or four compensation committee meetings a month. In doing that, these board members are thoughtful and independent and take their responsibilities very seriously.

They frequently vote down or modify management proposals on pay matters and, as a general course of business, they send more than 90 percent of stock-related proposals to the shareholders for their approval. Having said that, we think stock options should be approved by the shareholders.

Number seven. Executives have inside information that allows them to time their sale of stock, as well as the timing of their stock options grants and exercises. There is some reality and some myth to this. Executives have more inside information than outside investors, which is why many companies have black-out periods on the sale of stock.

However, I think this is an area that companies could police better. For example, requiring executives to announce ahead of time that they are going to sell their shares. This is something already covered by the securities laws, by the way.

Accounting for stock options. Current accounting rules for stock options are unfair to shareholders and there is no logical reason why these rules differ so much from the corporate tax rules. This is a myth.

Watson Wyatt and academic research show that shareholders are incorporating the amount of stock options into today's stock price, despite the fact that stock options are only disclosed and are not, in fact, expensed.

On how they got to this, the accountants may feel the need to change the accounting rules. There is, however, a basic logic to how they got there in 1973. The FASB did not look to the IRS for guidance, but to other accounting rules relating to corporate derivative securities' puts and calls.

They basically made the accounting for employee options consistent with those rules with derivative securities, namely, no impact on the income statement, dissimilar to the tax return.

The CHAIRMAN. I am going to have to have you summarize.

Dr. KAY. Yes. In conclusion, while executive pay remains controversial, I believe that the U.S. pay model has been much more helpful than harmful. Many of the perceptions about executive pay are false and not at all reflective. I do believe there are some areas, increasing stock ownership and managing stock sales, that could be improved.

Thank you.

The CHAIRMAN. All right. Thank you, Dr. Kay.

[The prepared statement of Dr. Kay appears in the appendix.]

The CHAIRMAN. Ms. Kennedy?

STATEMENT OF KATHRYN J. KENNEDY, ASSISTANT PROFESSOR OF LAW AT THE JOHN MARSHALL LAW SCHOOL, DIRECTOR OF THE CENTER FOR TAX LAW AND EMPLOYEE BENEFITS, CHICAGO, IL

Ms. KENNEDY. Thank you very much for this opportunity.

The purpose of my testimony is twofold. First, to dispel the myth that non-qualified benefits provide some massive tax loophole for executives, and then, second, to highlight some legitimate concerns Congress may have in this area.

Under the Tax Code, the employers' deduction for deferred compensation is generally matched with the employees' inclusion in income. However, if a qualified retirement plan is used, the employer is able to accelerate its deduction at an earlier time when the contributions are made, while the employee enjoys a tax deferral until the actual time of receipt. The assets are also protected in a 501(a) trust and may not be attached by creditors.

In contrast, when compensation is deferred under a non-qualified plan the monies remain with the employer and are taxed presently at corporate tax rates. Earnings are also taxed to the employer as they are earned. The executive is later taxed on the actual receipt of the deferral when the employer takes a corresponding deduction.

During this time of deferral, the benefits must remain subject to the claims of the creditors or otherwise be subjected to some potential future loss or forfeiture.

I would like to explain non-qualified benefits by using the analogy of an onion, starting at the very core and then adding different layers of security for the executive, and testing the resulting tax effects.

Step one. The simplest non-qualified plan exists where the executive has simply an unfunded and unsecured promise by the employer to pay some future benefit. There is no immediate tax consequence to the executive.

Next, let us allow the executive the ability to withdraw or accelerate the payment of these deferrals. The IRS has approved the use of such withdrawals, provided they are conditioned on certain triggering events, for example, change of control of the owner.

The Service has also approved the use of what are known as "haircut provisions," i.e., financial penalties that occur if, in fact, a withdrawal is made. Again, no current tax until time of receipt.

Next, could we set aside assets to assure that the employer will not later have a change of heart? The answer is yes. The IRS has approved the use of what is known as a "rabbi trust," provided that those trust assets remain subject to the claims of the employer's creditors. This is simply a grantor trust which continues to subject the employer to tax on the earnings.

Rabbi trusts have become so commonplace that the Service has issued model rabbi trust language. Unfortunately, such language was silent as to the use of triggering events or haircut provisions for early withdrawals. This has caused some confusion for practitioners.

Now let us go full circle. Let us totally secure the executives' rights to deferred benefits, even against creditors' claims. This can be accomplished by means of a secular trust, an irrevocable trust established by the employer providing exclusive rights to those assets for the executives.

However, as the executive's benefits are funded, he or she is immediately taxed on the amounts contributed to this secular fund, as well as their earnings, and the employer enjoys a corresponding deduction.

The end result, is the IRS, after it issued its model rabbi trust language also stated that it would not issue any advanced rulings on trusts that deviated from that model language. As a result, there has been uncertainty in using funding devices that go beyond the rabbi trust model language, but fall short of being a secular trust.

Here are some areas of concern. First, the use of an offshore rabbi trust, i.e., having the assets go outside the jurisdiction of the United States making it more difficult and expensive for the creditors of the employer to attach these trust assets. Unfortunately, the IRS has not issued any formal guidance regarding the use of such offshore rabbi trusts.

Second, use of what is known as a rabbicular trust, a rabbi trust that triggers funding and distribution upon some triggering event, such as change of control of the employer, and the resulting distributions being used to fund individual executive secular funds.

Certainly, if triggering events include such things as employer bankruptcy, insolvency, or liquidation, this should cause some tax problems. Again, we have had no guidance from the IRS.

Third, the use of a secured trust. This trust pays the benefits to the executives only if the employer goes bankrupt or goes insolvent. As the executives' benefits are subject to substantial risk of forfeiture, this has not caused any immediate tax consequences.

Finally, the use of a rabbi trust with a secured trust, which has been coined "the heavenly trust." The rabbi trust is funded and it is subject to the claims of the creditors, however, there is a tandem secured trust whose assets are paid to the executive only if there is a bankruptcy.

Obviously, the two trusts together insulate the executive from any loss and the service should rule that the executive is subject to immediate tax. Again, unfortunately, we have had no guidance from the Service.

Before legislative efforts are made, I suggest the following proposals. If the ability of the executive to prematurely withdraw benefits should be further restructured, I suggest you direct the IRS to issue guidance in this area.

Second, if executives are withdrawing benefits in anticipation of an employer's bankruptcy, I suggest the bankruptcy statutes should have greater look-back provisions.

If the magnitude of these benefits are in question, again, I would direct the IRS to exercise its already existing power to deny unreasonable and excessive deductions.

Last, with respect to the offshore rabbi trusts which do undermine the creditors, again, I direct the IRS to issue some guidance in this area.

However, if Congress' real motivation is to simply regulate the dollar amounts and types of compensation paid to executives, I would certainly question whether the Tax Code is the most expedient vehicle to do that. In this environment where Congress is trying to simplify the Tax Code, I suggest adding new layers of complexity at the individual and corporate level to reduce executive pay is simply counterproductive.

Thank you.

The CHAIRMAN. Thank you, Ms. Kennedy, very much.

[The prepared statement of Ms. Kennedy appears in the appendix.]

The CHAIRMAN. Mr. Biggs?

STATEMENT OF JOHN H. BIGGS, CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, TIAA–CREF, NEW YORK, NY

Mr. BIGGS. Thank you, Mr. Chairman, for inviting me. This has been an extremely interesting hearing that you have put together. I have had a number of ideas as we have gone along of things I would like to comment on.

I am here as the chairman of TIAA–CREF. We are a private pension system, primarily serving educators. We take a very long-range view of our relationship. Many times it is a 40-, 50-, 60-, and 70-year relationship, and hence, we are truly a long-term investor.

We manage about $275 billion in assets, which means that our analysts do look at an awful lot of financial statements. We think that our society and our economy have an overriding stake in the development and vitality of public corporations.

In fact, we see that as a principal source of the future retirement incomes of our participants. We introduced the variable annuity in 1952. We have, for a long time, encouraged our participants to invest part of their pension plans in stock, and many of them are quite rich today as a result of having done that over the years.

Accordingly, we devote resources to the advocacy of better corporate governance, which we believe will lead to better retirement incomes in the long run.

My experience on the stock option issue is not limited to TIAA–CREF. I have served as chairman of the compensation committee at Boeing that has adopted FAS123 and does expense stock. It is probably the only very large company that has done so.

I have also been on other public compensation committees where, I assure you, we know what stock options were worth.

I will use what has become a famous quote here: I am not an accountant. But I did start my career as an actuary and have a Ph.D. in economics. I have been, through fortuitous circumstances, very much involved in the oversight of the accounting profession, serving as a board member of the oversight group for the FASB, and now the International Accounting Standards Board, as well as the auditing side through the POB.

I have given you a much fuller statement, which we are filing with you, but I would like to briefly cover three areas on stock option accounting.

Before I get into that, let me endorse the statement that Bob Pozen made on the power of rotation of auditors. We have had that practice in our company since we have had auditors. Originally it was every 5 years. We now do it every 7 years. It is a wonderful cleansing process. I think it dominates any of the other possible ways to improve the quality of auditing.

If you have too much consulting fees to the accountants, eventually they go away when you have a new accountant come in. The peer review aspects of it, as he highlighted, are, I think, exactly the way to do peer reviews. It is much more successful than anything we have done in an organized way in the past in the oversight of the profession.

But let me talk first about the positive aspects of expensing stock options; secondly, what we believe the abuses have been as a result of not expensing them, and finally the importance we see in quality financial reporting.

I would state somewhat differently than Mr. Pozen. He cited that there was one form of option which does require expending, namely, the performance-related option. We are very sensitive to that because we have advocated a performance-type variable price option in many cases with companies.

We are very active in urging companies to change policies, particularly in executive compensation, and we have always run into the problem that he highlighted, i.e. that is an option which requires expensing, and so companies have not done it.

Boeing does have a performance-based system, a very powerful system that I think the company is delighted with. It has worked well as an executive compensation system. Therefore, we do expense the options and the other stock awards.

I think the correct way to say it, is that there is only one form of stock award under the current accounting rules that is "free", that is that there is no expense accounting. That form is the fixed price stock option. Any other form of stock award to employees is expensed under the old 1972 rules.

The FASB had a wonderful plan laid out in the early 1990's, but it was effectively shot down. It is now the preferred method. The FASB said this is the preferred method to do the accounting, but very few companies have adopted it because of the advantages of not having to expense at all.

I have met many times with corporate board directors and outlined the advantages to them of adopting the modern accounting principle which we have adopted at Boeing because it removes them from the straightjacket of this one limited form of option. I think the advantages to companies that are doing that are considerable.

Next, I would like to talk briefly about the abuses, if I have another minute.

The CHAIRMAN. Keep going. Go ahead.

Mr. BIGGS. We believe there have been a number of negative effects. First off, the explosive growth in the use of stock options since 1995. In some cases that we vote against, we will see that the outstanding options are 40 percent and more of the total shares in existence.

The distortion of earning statements is extraordinary. Companies can show tremendous earnings, and at the same time have actually no taxes they paid. Senator Levin has certainly highlighted that, though I agree with the reservations many of you have about using the Tax Code for effecting the change in accounting standards.

The unprecedented focus on the stock price at Enron was something that all of us who are outside Enron have observed. I think it was one of the corrupting aspects in the culture of that company. 60 percent of their people had stock options, and the extraordinary focus on the price of the stock certainly was a result of that wide use.

We also believe there has been a dramatic decline in dividends by corporations, because when a dividend is paid it reduces the value of the stock by the dollar that is paid. That comes out of the stock option award to the executives.

In other many cases, we think stock options have replaced pension plans entirely. We, needless to say, believe pension plans should be a part of a compensation system. We protested the action of IBM in gutting their defined benefit plan, and the company responded by pointing out that its competitors in the technology world had no pensions whatsoever.

But it has been the almost exclusive use of the fixed-price stock option which we think is the primary abuse. If we had a level playing field for the compensation committees in deciding what stock plan they would use, we do not think the fixed price option, as a "free" benefit, would have the kind of dominant role that it has had. Managements would have created better plans that align the interests of shareholders and management.

Finally, the repricing is something that we strongly oppose. The cynical and perverse six months and one day approach where you cancel the options and then you tell your employees you are going to issue new ones 6 months later, means that the employees have an incentive to get the price down in the next 6 months so that they get their new awards at a cheap price, and then they will get a much better pay off later on, again, driven entirely by the concern for the stock price.

A final brief comment. If a company wanted to demonstrate a real commitment to high-quality earnings, and there certainly appears to be a premium paid for that, or at least not a discount against low-quality earnings statements, we think the voluntary adoption of expensing stock options is a very smart action for companies to take and we are beginning to see that happen in a few instances.

We have gone to companies and strongly pushed for that, but we have not, so far, had overwhelming success in getting people to expense options. Thank you for the chance to testify.

The CHAIRMAN. Well, thank you very much, Mr. Biggs. That is very, very helpful. Thank you.

[The prepared statement of Mr. Biggs appears in the appendix.]

The CHAIRMAN. Mr. Heesen?

STATEMENT OF MARK HEESEN, PRESIDENT, NATIONAL VENTURE CAPITAL ASSOCIATION, ARLINGTON, VA

Mr. HEESEN. Thank you very much, and good morning. My name is Mark Heesen, with the National Venture Capital Association.

The venture capital industry is a relatively small industry. There are only several thousand VCs in the entire country. But, having said that, in the year 2000, venture-backed companies made up 5.9 percent of the Nation's job force and 13.1 percent of U.S. GDP.

Now, these venture-backed companies that we funded a decade ago are the very companies that institutional shareholders are investing in today. These are the very companies that you are investing in, and many others are investing in. We make up about 40 percent of Nasdaq companies over the last 3 years. So, it is an incredibly important sector of the U.S. economy.

Now, why did these companies get to where they were in such a short term? Most people would think, oh, it is the technology. New technologies have made these companies grow and prosper.

The reality is, as most venture capitalists will tell you, technology is extremely important, but it is management and technology employees that mean the most. Without good management, without employees, these companies go nowhere.

How do you incite employees? You incite them from a small, emerging growth company perspective through stock options. Why? Because we do not have the money to give to these kinds of employees as opposed to larger, more established companies. We have to have a way to get employees into our companies.

The way we do that, is trying to lure them away from more established companies to work for a young start-up, or even an emerging growth company that we simply do not know is even going to exist in a couple of years.

You give them those options hoping that they will work hard enough to make that company grow so that it does eventually go public, that it stays on the public market for a number of years, and then they get their reward.

Now, we are not only investors in companies, we are shareholders, we sit on the boards of directors of companies, and we take an active role in the management of companies.

But what we are here today to say is that we do think there have been abuses in stock options and we think that Congress has a legitimate role in looking at the abuses that have occurred in this area.

We think that enhanced disclosure of stock options is something that should be looked at by the SEC, and we are happy to see that they are doing that. We think that greater corporate governance rules are important. We think that there were a number of corporate directors asleep at the switch in some of these companies, and that should be looked at.

Having said that, we do not believe that S. 1940 is effective tax policy. Now, why do we think that it is not effective tax policy? First of all, today you do have employees giving, basically, the Treasury money. When they exercise their options, they have ordinary income which goes into the U.S. Treasury.

Then and only then does a corporation take a deduction. A corporation does not take a deduction for stock options if an employee does not exercise his or her options. It is a quid pro quo. That is exactly basic tax policy. If options are under water, if the employee has left the company, those options are not going to be exercised and the company will not get a corresponding deduction for those options.

Basically, you are the tax writers, and so you should create tax policy in the stock option area. My view is, basically, if you enact S. 1940, you are actually giving tax policy rulemaking to the FASB because you are basically forcing corporations to make a choice.

That is, if they want to expense options, they have to follow FASB's rules. FASB then becomes the arbiter of tax policy, in our view. So you are actually abdicating your role in tax policy, looking at S. 1940 the way we look at it.

As well, I think it is simply not good tax policy. Basically, the goal of S. 1940 is to match tax and financial books, but because stock options vest over so many years, that really does not occur.

Plus, you have the whole issue of Black-Scholes, which I know has come up on numerous occasions. We still believe that it is not a good method for valuing options, those being the types of options that we offer.

I think it is important to note that if we were forced to use Black-Scholes, you talked about earlier in the day, restatements would increase because you have to put so many more assumptions into your calculations that you would actually see an increase in the number of corporate restatements going on.

Bottom line, it is also, in our view, bad economic policy. There are other countries who are looking very strongly at our manner of how we give out stock options, and they are very impressed by the way we have done it.

Now, the U.K. is looking very aggressively at giving out more stock options in their companies. There have been movements by the International Accounting Standards Board to look at this issue, but frankly, the European Commission has come out with a very strong letter saying you should slow down and basically look at disclosure instead of direct expensing as an interim measure. So, I think it is important to note that.

Finally, I do think it is important to note that venture capitalists happily take dilution when we give out stock options, because without stock options there will not be a company at the end of the day. So, it is a very important point.

In conclusion, I reiterate that what is good about stock options must be preserved and made better, and we think they can actually be made better through comprehensive disclosure, better corporate governance, and greater accountability to shareholders. We look forward to working with you and the SEC and the other agencies which have jurisdiction over this over the next couple of months.

Thank you.

The CHAIRMAN. Well, thank you, Mr. Heesen, very, very much.

[The prepared statement of Mr. Heesen appears in the appendix.]

The CHAIRMAN. I will turn, first, to my colleague, Senator Grassley, for questions.

Senator GRASSLEY. Well, I did not ask questions of the first panel because, quite frankly, I did not have any. But I want to thank the first panel for their contribution to this very important issue before us, and to also thank the second panel.

I am going to start with Dr. Kennedy. I think you make very clear the point that supposed problems with non-qualified compensation plans are overdone. You also make the point that we have certain limits on qualified plans that drive people, drive companies in that direction.

What limits would you recommend for qualified plans to reverse the trend towards non-qualified plans, and is that the direction you think that we should be going?

Ms. KENNEDY. Well, quite frankly, I do not think the Tax Code should drive the business decision as to how much a CEO should be paid. In fact, an example of that is Congress' enactment of 280(g) of the Internal Revenue Code.

It was a method by which corporations would be limited in their deductions if they paid excessive parachute payments, i.e., if there was a change of control and the executive was forced out, there would be a parachute payment. Congress perceived that to be excessive so it denied the deduction on the excessive portion and then taxed the individual as well with a 20 percent penalty tax.

What we have in fact seen, though, since 280(g)'s enactment, is companies exceed the parachute amount all the time and simply do not take the deduction. In fact, they gross up the executive for the amount of the 20 percent penalty.

If it makes business sense to go ahead and make those parachute payments, they are going to be made regardless of the consequences under the Code. So, I really question whether the Code is the method in which you want to limit the dollar value of compensation to executives.

Senator GRASSLEY. Mr. Heesen, do you believe that the venture capital industry would be supportive of a proposal for greater disclosure in the financial statements of diluted effective stock options?

Mr. HEESEN. Yes, I do. I have talked to several venture capitalists precisely on that issue and they would not be averse to seeing dilution tables put into a specific—be it a yearly report or if it is even quarterly. They would not be averse to that.

Senator GRASSLEY. Dr. Kay, your testimony suggests that the field of executive compensation, while not perfect, is subject to considerable scrutiny and pressure to match performance and compensation levels.

If you were to recommend areas to improve the overall system, what would you recommend? I specifically want to know whether or not those should be legislative or market-based.

Dr. KAY. Well, on the specific question that was asked earlier about whether this is a FASB issue or an IRS issue, the stock option accounting, I believe very strongly that it is a FASB issue and it should be put back to the FASB.

I think that, of the many, many controversies that have come out over the past few weeks, the one that seems the most disturbing and that is the hardest to fix is this issue about, somebody makes $100 million, or $20 million, or $500 million on their stock sale or stock option exercise and then the company does not do well, either through just bad luck or through fraud.

I believe that a big improvement which would probably make a lot of executives unhappy, which might be a good thing, would be is if executives, before they exercise or before they sell, if they had to announce their intention.

Now, there is actually academic literature on this issue about, is a bearish signal or a bullish signal as to when executives sell or when they buy. It actually turns out that there is not that much information in there.

But, nevertheless, I think that that would make very good policy and would certainly signal to the marketplace what the executives are thinking about the prospects for their company.

Senator GRASSLEY. All right.

Mr. Heesen, could you elaborate on the hazards of allowing accounting oversight bodies such as FASB and SEC to determine the timing and the amount of tax deduction allowable for stock options?

Mr. HEESEN. Well, I think that the role of tax policy is yours and you should be the ones who dictate when that taxable event occurs. That is not the role of the SEC or the FASB. I think, in consultation with Treasury, you have, basically, that obligation.

Senator GRASSLEY. Also, for you, could you describe what you believe would be the practical effect and industry reaction to the Levin-McCain bill?

Mr. HEESEN. From a small emerging growth company perspective, it hurts us dramatically because we do not have any other way to recruit employees. So, we will have to continue to give stock options. No matter what happens, we will have to give stock options.

Over the last 10 years when this debate has been raging, you would have hoped that someone would have come up with some other mechanism to incite employees that we would not have to come back here every couple of years. But that has not occurred. So, we will continue to give stock options.

Unfortunately, your much larger, more established companies are going to figure a way to incite their employees. They certainly have money to do that, or they can do it in other manners. But we do not have that opportunity, frankly.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Mr. Biggs, why should fixed and variable options be treated the same?

Mr. BIGGS. Well, I think if they are treated the same, the companies will adopt whatever is best for their incentive plan. They are not going to be biased by an arbitrary accounting rule to pick one over the other. The effect is very powerful, as we have seen with the overwhelming dominance of the fixed-price stock option.

The CHAIRMAN. I just need a little education here. Why are variables expensed and fixed amounts?

Mr. BIGGS. The rule that the accountants came up with in 1972—and which they wanted replaced with FAS123 in 1995—reflected the fact that stock options were very limited in their use in 1972.

They came up with that definition of a fixed-price stock option because they said you could determine the value of it at that time, the so-called intrinsic value of the option.

But anything that did not have a fixed price, they said we cannot determine that so you will have to expense it as you go along. The way it is expensed is unacceptable. Each time the stock moves in price, you have to go in and expense it, so nobody in his right mind would ever, ever adopt such a plan.

I was on the board of a company, Ralston-Purina, when we adopted a variable price performance plan where you had to exceed the S&P 500 over a 5-year period. The board loved it. We thought that was a great plan. If management succeeded, they got very generous awards.

This was back in the early 1990's. Somehow or other, the management and the accounting firms were asleep at the switch and did not realize what that was going to do to them under APB25, the 1972 rules. So, they had to hit their earnings statement every time there was a change in the stock. Regrettably, we abandoned the plan and we simply said, all right, if the stock goes up you get an award.

Let me comment a little, if I may. It seems to me during the 1990's a major reason, unrelated to any company's performance, for the growth in stock was the spectacular decline in interest rates that we had during the 1980's and 1990's.

Long-term interest rates dropped dramatically over that period. It is a simple theory of finance that when that happens, the price of stocks goes up across the board. All of them do.

All earnings are discounted at a lower rate, so you have more value. Why in the world did we pay out hundreds of millions, billions of dollars to executives under a fixed price stock option for their company stock going up due to interest rates rising for which they had no responsibility?

So our simple answer is, if you do as well as an index or you have a certain absolute hurdle rate, that ought to generate very substantial awards. I do not mind paying someone 100 million bucks if they do a lot better than the S&P 500 for us; our shareholders have gotten a real benefit.

But I do object when we pay them $100 million, and there are such instances, when they do not even match the S&P 500. We can do better with an index fund and turning the money over to that manager.

The CHAIRMAN. Mr. Heesen, it has been suggested that shareholders should approve stock option plans. Do you agree?

Mr. HEESEN. We think that we would love to work with the SEC on that issue. We think that there are areas that we could definitely agree on on shareholder approval. We would have to look at all the specifics. But, in general, we are supportive of shareholders looking at and approving these plans.

The CHAIRMAN. And approving.

Mr. HEESEN. Yes.

The CHAIRMAN. What about an independent audit committee putting out an RFP and rotating auditors every 5, 6, 7 years?

Mr. HEESEN. Most venture capitalists actually think that that is a good idea. There is more concerned from our perspective on audit committees on the definition of independent and whether venture capitalists actually are "independent." That is the same on the compensation committees.

The way the rules could be written, is that some of your smartest people are going to be forced off of those committees because they are not independent if a venture capital firm held a certain percentage of the stock. That is, frankly, more of a concern. But the audit rotation is something that most venture capitalist firms would have no problems with.

The CHAIRMAN. How would you deal with that issue, that tension, Mr. Biggs? It sounds like venture capital firms invest in smaller companies and there is some person that is a real driver in the company but would not be as involved as, let us say, like a Boeing.

Mr. BIGGS. I think that is really tough for the smaller companies because their ability to just get independent directors to come in and serve on those boards is very limited.

The venture capitalists themselves who are major investors do play that role, and they would be independent by most standards. But that is harder for them than it is for a very large company. I would concede that.

The comment I want to make, is this: we are a major investor in venture capital companies. We have over $2 billion invested in venture capital firms. My observation of that the real problem of the small fund companies that venture capital firms finance is cash and how fast they are "burning" their cash, as they say. It is not the earnings statement. The reason they prefer to give equity interest to their employees is that it does not require a cash transfer. What they are short of is cash.

The effect of having to show a cost in their earnings statement for the stock plans that they give seems to be reasonable, and it should not cause great difficulty because their earnings statements are interpreted very carefully by the venture capital firms that own them.

The real pain for them always is, do they have enough cash to pay salaries? Salary usually requires you to actually give some money to somebody. Stock is something else.

The CHAIRMAN. I did not ask this question to the previous panel. I should have. But you are here now, so I will ask you. What about these SBEs, all the off-balance sheet transactions?

Presumably, an independent audit committee would be a little more rigorous in trying to determine how many off-balance sheet transactions there are. I am speaking of Enron, for example, and there are some others. Your thoughts?

Mr. BIGGS. I think it is a very difficult subject, because most SBEs are perfectly legitimate and appropriate for companies, and there is a good reason why they are doing it. They are using their credit position in some way to further the interests of the company.

But it is a complex transaction. It is easy to abuse it. One of the aspects of Enron that most troubled me, was that the accounting firm, Arthur Andersen, designed the SBEs to just skirt the accounting rules, right on the edge of the accounting rules, and felt very clever about how they had done it.

It was a high-value service they were giving and they charged a lot for that. They then turned around and audited it and said, yes, they comply with accounting rules. That conflict was so brazen, it really was shocking.

But I think special-purpose entities involving off-balance sheet finances are appropriate. We just created one in my company, and I took it to my board right after the Enron disclosure. I said, this is a special-purpose entity, it is off-balance sheet, but you understand what we are doing. We have a AAA rating as a company.

We were able to create a company off-balance sheet of our company. We guaranteed its bond issue and it raised $1 billion and immediately invested it. It had a AAA rating and we immediately invested it in single A portfolio securities, creating very generous earnings which will come back to our participants.

And everybody can see exactly what it is. We have made the guarantee, the rating agencies understand it. We went to the rating agency, described it to them very carefully. It was so simple.

The CHAIRMAN. So you are basically saying it is a matter of disclosure.

Mr. BIGGS. No. I would go beyond that. Enron could have tried to disclose what they were doing. I am not sure anybody would have figured it out because it was so complex.

The CHAIRMAN. That is right.

Mr. BIGGS. It certainly should be disclosed. But there still could be abusive arrangements in that. In my opinion, the Enron SBEs were clearly abusive.

The CHAIRMAN. Other related subject offshore tax havens, inversions. That is, where Ingersoll-Rand and some other companies just invert their corporate structure so they are incorporated in the Cayman Islands, and Bermuda and pay no U.S. income taxes. It is a trend that seems to be developing.

Mr. BIGGS. Right.

The CHAIRMAN. How do we address that?

Mr. BIGGS. I do not know. It has been suggested occasionally that our company do something like that, and I just said I do not want to be tainted by the appearance even, the optics, or whatever you want to call it, of that kind of a transaction.

Providing self-insurance is the usual way a lot of companies have done that, and it is done very widely. For the life of me, I do not understand why the Tax Code permits the same transactions by a U.S. company to take place by simply using an offshore entity.

The CHAIRMAN. I agree with you. We will see what we can do about that. All right.

Thank you very much, everybody. We appreciate your taking the time to come. You have put in great effort and you have worked hard to help this panel. Thank you very much.

The hearing is adjourned.

[Whereupon, at 11:50 a.m. the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

John H. Biggs
Chairman, President and Chief Executive Officer
TIAA-CREF

TIAA-CREF is the largest private pension system in the world, providing pensions and other financial products to the education and research community. We manage about $275 billion in assets through TIAA, a New York licensed stock life insurance company, and CREF, the country's first variable annuity plan. We also offer to the general public life insurance products, trust services, mutual funds, and college tuition savings plans.

In addition to my role as Chairman, President and Chief Executive Officer of TIAA-CREF, my other experience relevant to your deliberations is as an independent public sector participant in financial regulation. I served for two years as a Governor of the NASD and some five years as a Trustee of the Financial Accounting Foundation, which funds the Financial Accounting Standards Board, or FASB, and appoints its members. I now serve as a Trustee of the Foundation supporting in a similar way the new International Accounting Standards Board (IASB). I was also a member of the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees. I served as one of the five trustees, all of us independent, of the Public Oversight Board, which went out of business on March 31, 2002. I presently serve on the Board of the Boeing Corporation. I am not an accountant but did start my career as an actuary and earned a Ph.D. in economics along the way.

I believe that all types of employee stock options should be expensed in income statements. Shares of stock given to employees are required to be expensed. Options given to nonemployees must be expensed. The current accounting rules, written in 1972, requiring an expense charge for performance options, but zero expense charge for fixed options given to employees, make no sense. In this statement, I describe in detail the problems with current accounting requirements, the perverse incentives created by these accounting requirements, international efforts to change accounting rules, and various related issues including shareholder approval of option plans, academic research, and option repricing.

TIAA-CREF has been active in the corporate governance arena for about 15 years, and we continue to be active on many issues. We believe board independence and independent key committees are essential for good corporate governance. We closely follow executive compensation practices at our portfolio companies. One of our significant issues this year is shareholder vote reform for all material option plans. However, good financial reporting is a key ingredient in good corporate governance. The accounting rules for stock options in the U.S. are influencing behavior in ways that are counter to investor interests. A level playing field across all types of options is necessary to bring more rational pay schemes into existence.

There has been a significant amount of press coverage about executive compensation, in particular, the stock option issue, in the last few months. In the post-Enron environment, questions have been raised about whether employee stock options contributed to an atmosphere in which employees were more focused on the stock price than on "doing the right thing." Many have questioned whether the current accounting is a reasonable representation of the actual economic events. From Federal Reserve Chairman Alan Greenspan to President George W. Bush, the accounting issue has been raised. In Appendix A, I include the full texts of recent testimony by Chairman Greenspan and Nobel Laureate Professor Joseph Stiglitz. Also included is a letter to the editor of the New York Times from Stephen Barr, an editor of CFO magazine.

Chairman Greenspan describes what he views are severe market distortions from not showing a significant cost from options in reported financial statements, and he also rejects several critics' arguments against option expensing. Professor Stiglitz discusses misinformation in the markets, and also supports the idea that reasonable estimates of value are available and should be recognized as expense. Interestingly, Mr. Barr of CFO magazine looks at the issue from a different angle. He asks what would be different today if the FASB had been successful in the mid-90s and expense treatment for all options had been required. His conclusion is that our economic situation would be exactly the same; however, there might be fewer questions about accounting "gamesmanship."

Overuse and Abuse of Stock Options

There is no question that current accounting rules for options are driving behavior in employee compensation. The current rules that govern option accounting, written in 1972, are absurd. Among other things, those rules allow fixed at-the-money options to be viewed as "free," regardless of how many are issued, even though those options form a central feature of executive compensation plans and obviously have very substantial costs.

Most companies use stock and stock options to pay employees. In the S&P 500, 99% of the companies provide stock options to employees, and only two of those companies show expense for stock options. As a result, earnings in 2000 were overstated by about 12%. Tax benefits, via corporate deductions for compensation, from options averaged nearly $3,000 per employee. Sixty-eight percent of companies had share buyback programs, and they used an average of 48% of net income to reacquire those shares.

The Association for Investment Management and Research (AIMR) published survey results in November 2001 from 1,944 worldwide analysts, in which more than 80% said that employee stock compensation should be required to be shown as expense in earnings.

The tax benefits recognized in 2000 were enormous, with technology companies in the S&P 500 showing an average tax benefit of $234 million. The IRS allows as a deduction for compensation expense the difference between the option price and the stock's price when it is exercised (for most employee stock options). But in reports to shareholders that difference, or any other amount, is never shown as an expense. The Levin-McCain-Fitzgerald-Durbin-Dayton bill, "Ending the Double Standard for Stock Options Act," S. 1940, would call for limiting the tax deductions to the amount shown in financial statements as option expense. For all but a handful of companies, the bill would have a tremendous effect, presumably on reported earnings.

We support the objectives of that bill—to end the fiction that options have no cost for GAAP financial statement purposes. We agree that expense for options should be shown on income statements, particularly when large tax deductions are taken for compensation expense from employee options. It simply isn't credible for companies to say that no reasonable estimate of value for employee options is possible for income statements, when those same companies recognize large option expense amounts for tax purposes. TIAA-CREF would like to see financial reporting improved in a direct way—via changes to the accounting rules—rather than amendments to the tax code. The U.S. tax code has built into it all sorts of incentives, and those incentives result in differences between GAAP reporting and tax reporting, not necessarily a bad result. The current taxation rules generally result in individual income tax on the realized gain. For the most part, that same amount is the deductible expense for the company. Although the legislation has a certain appeal, resulting in symmetry between tax and financial reporting for option expense, we would prefer to address the financial reporting deficiency directly.

FASB Efforts

Through its long and open process the FASB explored all theoretical aspects of stock options during the late 1980s and early 1990s. It put out tentative proposals, conducted exhaustive hearings so that all participants could comment, and heard arguments pro and con. The process took several years.

Many critics now say the FASB is too slow, but at other times critics have said it was too fast, especially when the issue was an unpopular one such as stock compensation or derivatives. The original 1993 proposal would have required a charge to expense for stock options given to employees as compensation. After extensive lobbying of Congress by companies and auditing firms, and following legislative threats to the existence of private sector standard setting, the FASB and the SEC capitulated. Arthur Levitt has publicly stated that he believes this was the greatest mistake made by the SEC during his chairmanship.

In capitulating, the FASB published a rule in 1995, known as Financial Accounting Standard 123, *Accounting for Stock-based Compensation*, that offers the choice of expense recognition or disclosure in footnotes. Expense recognition is stated as the preferred method, but only a few companies have adopted the expense alternative. If disclosure is chosen, the income statement will show expense for options only under certain circumstances required by the Accounting Principles Board (the predecessor to the FASB) in its Opinion No. 25 (1972). Opinion 25 requires expense for most performance options, and any other award that is considered "variable" under its terms. If all of the option award's characteristics are fixed at the date of grant, expense is measured as the difference between the exercise price and the market price of the stock. Although a few options are granted above or below current market prices, the vast majority of options are granted "at-the-money," resulting in a zero expense.

Variable awards, such as indexed options, result in expenses that change as market prices change until the options are exercised. Indexed options tie the employee exercise price to a market or peer index, generally meaning that the company's stock price must outperform an index before the options are exercisable. Those types of options can work in both increasing and decreasing markets. Compensation is paid if the company's performance is better than peers, even if "performance" is a lesser decrease than other companies in the index. We would be very happy if more companies adopted performance based option plans. In down markets, repricings would not be necessary if indexed options were used. However, most corporations want to avoid uncertainty and volatility in earnings, and therefore reject performance-based options. The 1972 accounting rule is discouraging the use of performance awards. Significantly, most companies use virtually no other form of stock award than the fixed at-the-money option, which is treated as "free" under obsolete accounting rules.

The FASB said the following in Statement 123, with which I completely agree: "The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue—not because it believes that solution is the best way to improve financial accounting and reporting." (Paragraph 62) In other words, disclosure in footnotes is inappropriate reporting to shareholders of the costs of operations.

As you might expect, most corporations prefer to use the obsolete 1972 accounting model, which treats the fixed price stock option as "free" and treats performance options as potentially very expensive. Companies are required to disclose in a footnote what the cost would have been, and show the pro forma net income and earnings per share, if an expense charge for options had been recognized. Statement 123 calls for a fair value measure at the date of grant. The Black-Scholes option-pricing model, with adjustments for the differences between employee options and traded options, is the basis for the measurement.

Note that the Black-Scholes option-pricing model was created in 1973, one year after the APB issued Opinion 25. That seminal work forms the basis for understanding a myriad of financial transactions involving uncertainty. I can assure you that company executives and compensation consultants routinely use the Black-Scholes model to value employee options. Most companies also use Black-Scholes to communicate total compensation to employees. Those same executives know that having to show the results of that calculation to shareholders would reduce or in some cases eliminate the earnings of their companies.

I serve as a Director of the Boeing Company, which is one of the few major U. S. companies to adopt Statement 123 expense, in order to report to its shareholders the true cost of its stock compensation plan. Boeing's executive compensation plan is based heavily on tough performance tests that are prohibitively expensive under the 1972 accounting model used by all other companies. For the record, Boeing adopted its plan and Statement 123 in 1996, before I became a director.

I might mention a further example of the strong-arm tactics of U. S. corporations. Last year the Financial Executives International issued a press release threatening to withdraw funding for the newly formed International Accounting Standards Board if the Board dared to study the issue of accounting for stock-based compensation. At that time, both the FEI and the National Venture Capital Association wrote letters to SEC Chairman Harvey Pitt asking the Chairman to focus on the issue, describing what they view as negative consequences of accounting standards.

The use of options and stock as employee compensation is a growing phenomenon overseas, with little or no accounting guidance in place. In international literature, there is scant attention paid to transactions paid for in stock, let alone stock options. It is possible to pay expenses to outsiders with stock and show zero expense, which surely is an area that must be addressed. I am happy to say that both Paul Volcker, Chairman of the Foundation supporting the IASB, and Sir David Tweedie, Chairman of the IASB, are standing their ground, and the project is proceeding. An Exposure Draft is expected by the end of 2002, and the IASB has been deliberatively studying the issues raised in a discussion paper issued in 2000 by the previous International Board and other standard setters, commonly known as the G4+1.

Diluted Earnings Per Share is Not a Solution

Diluted earnings per share cannot and does not measure the cost of employee stock options. Diluted earnings per share is a measure of earnings that is required to be shown by FASB Statement No. 128, *Earnings per Share*. It requires that a performance measure be shown in two ways—basic earnings (net income from the income statement) per share and diluted earnings per share. The following is a general, simplified summary of the accounting for earnings per share. The diluted earnings per share measure starts with the same net income amount as basic earnings per share for the numerator. However, the number of shares used in the denominator for diluted earnings per share is changed to show the "pro forma" effect of a number of items, including convertible debt, written put options, forward purchase contracts, warrants, and stock options. The number of shares to use for diluted earnings per share must include only those instruments that would be dilutive. For example, only options that are "in-the-money" are included, not all outstanding options.

An example illustrates how the current accounting for earnings per share is done. If a company gives an employee a share of stock, not an option, the company must show two effects—both the cost of the share and the increase in outstanding shares. That share issuance is reflected in net income as a cost, and the earnings per share measure would use an increased number of shares. A similar accounting result occurs if a company sells options for cash and gives the cash to employees. There is both a cost and an effect on shares outstanding.

For most stock options issued directly to employees, accounting rules do not require that a cost be shown in earnings. The result is that only one part of the option issuance is shown to investors. That dilutive effect on outstanding shares also is shown only if options are "in the money". There clearly is a potential dilutive effect from options that are out-of-the money. The cost of options is not recognized in net income and therefore cannot be reflected in any measure of diluted earnings per share.

Stock options are simply another form of equity that should be treated in the same way as shares of stock. When diluted earnings per share is proposed as a solution for stock option accounting, it simply is a smokescreen. The two accounting measures are like apples and oranges and should not be linked. Both are important measures to investors. However, the real issue is that there should be a cost for employee stock options in earnings.

Post FASB Statement 123 Activity

The use of questionable accounting methods for stock options has had several negative results:

(1) **Explosive growth in the use of stock options since 1995—huge, indeed, incredible awards to CEOs and in some companies awards to every employee.** For several years, the increasing number of issued options has been a major concern addressed by TIAA-CREF's corporate governance program. We vote at all of our portfolio companies, using guidelines, including "red flags" for large potential dilution from stock option programs. At some companies, options outstanding or available for grant exceed 40% of the total shares outstanding. At those companies, we are voting against option plans, and we expect to continue to do so. See later discussion about the right of shareholders to vote on material option plans.

(2) **The serious distortion of earnings statements so that some companies report large earnings at the same time that no taxes are paid.** This is because of peculiar accounting that results in fixed price stock options as zero "cost" in public income statements while allowing the employee gain from most options to be shown as a "cost" for the tax return. Tax deductions and the option program itself are sources of cash flow for companies, some to such an extent that cash flow from option exercises exceeded cash flow from operations in 2000.

(3) **Unprecedented focus on the stock price by all the employees of the company, to the point where serious ethical dilemmas are posed for employees.** When excessive stress is placed on company accountants and their auditors, malfeasance may result. Business ethics experts wonder if potential "whistle blowers" are intimidated by their colleagues or their own concern for their stock options.

(4) **The dramatic decline in dividends is a direct result of so much recent attention to stock options.** A dollar per share paid to a shareholder as a dividend reduces the stock price by a dollar. Can anyone wonder why corporate managers find many reasons to justify a reduction or elimination of the dividend?

(5) **In many companies, stock options have replaced pension plans entirely.** When we protested the action of IBM in abandoning its

defined benefit plan, the company responded by pointing out that its competitors in the technology world had no pensions whatsoever.

(6) **There has been an almost exclusive use of the "fixed-price" stock option in employee compensation plans.** More desirable stock compensation plans could be devised that would better align management and shareholder interests. Plans such as performance options or indexed options are effectively prohibited by the 1972 rules because they require that management show an expense for them. FASB Statement 123 provides sensible expense accounting for performance plans, and provides similar accounting for options issued to employees and nonemployees alike.

(7) **The recent downturn in the market has resulted in option repricings, in which employees exercise prices are reduced to reflect market price declines.** The majority of recent repricings have been effected using the "6-and-1" approach, avoiding any accounting expense for the repricing. See the section titled, "Repricings" that follows for a complete description of the issue and the problem.

Need for Shareholder Approval

Until recently, shareholders had little disclosure of how many options were being authorized. New SEC requirements will be in effect next year calling for disclosure of options, with separate disclosure of option plans approved by shareholders and options not approved by shareholders. We applaud the SEC for implementing new disclosure rules. However, we are concerned that under "broad-based" exceptions to stock exchange shareholder approval requirements, increasing numbers of boards have implemented stock option plans without seeking shareholder approval. The SEC estimates that 20% of publicly traded companies with equity compensation plans have plans that have not been approved by shareholders. In the technology environment, compensation consultants estimate that approximately 30% of companies have option plans that were not approved by shareholders.

TIAA-CREF and other institutional investors for several years have encouraged the New York Stock Exchange and NASDAQ to strengthen shareholder-voting requirements. The NYSE established a task force in 1999 that articulated a reasonable compromise on this issue, but the NYSE had been unwilling to implement the proposal unless NASDAQ adopts a similar standard. (More recently, the NYSE has said that it may move forward on elements of the proposals without NASDAQ.)

The NYSE task force compromise would require shareholder approval of any plan for which directors and/or executives are eligible, and would limit the amount of potential dilution from plans that have not been approved by shareholders to 10% of the equity compensation plan shares that have been approved by shareowners. To date, NASDAQ has declined to accept this dilution standard, though NASDAQ appears willing to accept the voting requirement for plans for executives and directors. SEC Chairman Harvey Pitt has urged the exchanges to take action, and we are hopeful that NASDAQ may soon move forward on this issue. TIAA-CREF has had discussions with several companies regarding option plan approval policies. Those companies targeted for discussion maintain significant stock option plans that have not been approved by shareholders. Option grants under these plans, most of which have been in place for only a few years or less, run up to 40% of shares outstanding.

We believe that all material option plans should be put to vote of shareholders, regardless of the option recipients. These option plans materially dilute our ownership interest and the shareholder vote is critical.

Repricings

If stock prices decline, companies might want to consider whether options granted in the past are continuing to provide the incentive and the compensation that were intended with the initial grant. If options are significantly "out-of-the-money," they likely do not serve as much of an employee incentive. Many companies reprice employee options to retain and motivate employees. Certainly, employees have the ability to go to work for another employer and receive new options. Accounting treatment for repricings is diverse, depending on the method of repricing. FASB Statement 123 calls for a reasonable approach to repricings. A value-for-value exchange is computed at the date of exchange and any additional value conferred is recognized as expense over any new service period.

Because most companies do not use Statement 123 for expense recognition, the FASB interpreted APB Opinion 25 and issued repricing guidance in 2000, included in FASB Interpretation No 44. If options are repriced in a straightforward way—simply reduce the exercise price of existing options—the original options are considered variable under Opinion 25, resulting in expense. If however, an exchange is organized such that employees return the old options, and the company waits at least 6 months before issuing new at-the-money options, the new award can be considered fixed, resulting in zero expense. Clearly, the 6-month waiting period provides unusual incentives to employees. Investors are concerned that employees would be motivated to lower stock prices during that 6-month period before new options are granted. The "alignment" achieved via the "6-and-1" repricing seems to be alignment with short sellers, not the expected alignment of interests between employees and shareholders.

In a study of 170 repricings in 2001, Institutional Shareholder Services reports that 74% of repricings were effected through the "6-and-1" approach. Seventy-three percent of companies repriced on a share-for-share basis, meaning that the same number of options were exchanged, rather than a value-for-value exchange. Fifty-five percent left the same vesting schedules in place for the new options. Perhaps most disturbing, however, is the fact that 60% of the companies repriced options for officers and/or directors. In earlier repricings, most companies repriced options only for those employees below the executive ranks.

The Opinion 25 interpretation for a "6-and-1" repricing is difficult to understand, except in the context of the 1972 rule on which it is based. If the terms of awards are fixed and issued at-the-money, no expense is recognized. If the award is variable, expense is recognized. This and other ad hoc interpretations of Opinion 25 lead us to conclude that the basic model for employee options is in surely need of reform. Even-handed treatment for slight variations in awards is possible only if the basic model is sound.

<u>Academic and Other Research</u>

In April 2001, the TIAA-CREF Institute, in cooperation with the TIAA-CREF corporate governance staff, sponsored a Corporate Governance Forum, *Executive Compensation, Stock Options, and the Role of the Board of Directors*, at which the issues of executive compensation and the use of stock options were examined and discussed in detail. The forum brought together academics, compensation consultants, corporate officers and directors, corporate human resources personnel, institutional investors, regulators, and other practitioners. Several points about options as incentives were made. For example, stock prices may be a poor measure of employee performance, because stock price changes are beyond the control of most employees. The issue is whether option plans reward employees for superior performance—or for luck.

Academic research suggests that employees place a lower value on stock options than the potential cost of those options. It also was argued that option-based compensation may not be appropriate for employees at lower levels in the corporation because of the risk involved.

Some academic research seems to conclude that current stock prices reflect information reported in footnotes about employee option costs. One research paper says, " . . . stock-based compensation expense has a negative relation with share price, consistent with investors viewing it as an expense of the firm. This finding calls into question the quality of reported earnings, because without recognition of stock-based compensation expense under SFAS 123, this expense is never included in net income. It also indicates that stock-based compensation expense is measured with sufficient reliability to be reflected in investors' valuation assessments." (*SFAS 123 Stock-Based Compensation Expense and Equity Market Values*, David Aboody, Mary Barth, and Ron Kasznik, 2001) Another research paper seems to say that market prices reflect option costs, but also that option exercises provide additional information to the market. (*Do Stock Prices Incorporate the Potential Dilution of Employee Stock Options?*, Gerald Garvey and Todd Milbourn, 2001)

A complete summary of the April 2001 TIAA-CREF Institute forum can be found on the Institute website at www.tiaa-crefinstitute.org. The following is an excerpt from the summary:

> Two observations suggest that financial accounting considerations may unduly influence compensation policy: first, the continued use of standard at-the-money options relative to potentially superior alternatives such as performance-based options; and second, the gaming of the accounting system, particularly in the case of the synthetic six-month-plus-one-day repricings. The proclivity of companies to adopt compensation policies to avoid a charge to earnings is somewhat disturbing. Indeed, it leads one to question whether a myopic focus on measured earnings and earnings per share distorts economic decisions and results in the adoption of suboptimal compensation programs.

Conclusion

Private sector standard setting has worked well in this country, via the FASB or GASB (the Governmental Accounting Standards Board), and I am supportive of the private sector International Accounting Standards Board. It is untenable for any government to directly set accounting standards. Congress, through the political process, should not enter into technical issues of accounting rules, but it should oversee the system through the SEC and should demand a fair and open process. Some expression of support by your Committee might make it possible for there to be improvements to the required accounting rules. Although expense recognition is stated as the preferred approach by the FASB, unless some action is taken, we are concerned that current indefensible accounting rules for employee stock options will continue.

APPENDIX A

Speech by Federal Reserve Chairman Alan Greenspan New York University, March 26, 2002:

Some changes, however, appear overdue. In principle, stock-option grants, properly constructed, can be highly effective in aligning corporate officers' incentives with those of shareholders. Regrettably, the current accounting for options has created some perverse effects on the quality of corporate disclosures that, arguably, is further complicating the evaluation of earnings and hence diminishing the effectiveness of published income statements in supporting good corporate governance. The failure to include the value of most stock-option grants as employee compensation and, hence, to subtract them from pretax profits, has increased reported earnings and presumably stock prices. This would be the case even if offsets for expired, unexercised options were made. The Financial Accounting Standards Board proposed to require expensing in the early to middle 1990s but abandoned the proposal in the face of significant political pressure.

The Federal Reserve staff estimates that the substitution of unexpensed option grants for cash compensation added about 2-1/2 percentage points to reported annual growth in earnings of our larger corporations between 1995 and 2000. Many argue that this distortion to reported earnings growth contributed to a misallocation of capital investment, especially in high-tech firms.

If market participants indeed have been misled, that, in itself, should be surprising, for there is little mystery about the effect of stock-option grants on earnings reported to shareholders. Accounting rules require that enough data on option grants be reported in footnotes to corporate financial statements to enable analysts to calculate reasonable estimates of their effect on earnings.

Some have argued that Black-Scholes option pricing, the prevailing means of estimating option expense, is approximate. But so is a good deal of all other earnings estimation, as I indicated earlier. Moreover, every corporation does report an implicit estimate of option expense on its income statement. That number for most, of course, is zero. Are option grants truly without any value?

Critics of option expensing have also argued that expensing will make raising capital more difficult. But expensing is only a bookkeeping transaction. Nothing real is changed in the actual operations or cash flow of the corporation. If investors are dissuaded by lower reported earnings as a result of expensing, it means only that they were less informed than they should have been. Capital employed on the basis of misinformation is likely to be capital misused.

Critics of expensing also argue that the availability of options enables corporations to attract more-productive employees. That may well be true. But option expensing in no way precludes the issuance of options. To be sure, lower reported earnings as a result of expensing could temper stock price increases and thereby exacerbate the effects of share dilution. That, presumably, could inhibit option issuance. But again, that inhibition would be appropriate, because it would reflect the correction of misinformation.

Testimony of Dr. Joseph Stiglitz, Nobel Laureate Professor of Economics, Columbia University
Senate Banking Housing and Urban Affairs Hearing, "Review of U.S. Economic Health"

Tuesday, March 12, 2002:

At the time I served on the Council of Economic Advisers, we raised strong concerns about conflicts of interest and problems in accounting standards and practices, particularly as they related to derivatives and options. Our concerns have proved to be on the mark. There were others who raised similar concerns. Arthur Levitt, of course, was right in calling attention to the conflicts of interest in the accounting firms, when they simultaneously provide consulting services. FASB called for a changing of accounting practices to more accurately reflect the costs of options given to executives. I strongly agreed. The Secretary of Treasury and the Secretary of Commerce, however, violated basic principles of good governance, which call for the independence of FASB, and intervened to squash the proposed revisions. They succeeded.

I have devoted much of my academic life to the economics of information, and to the consequences of imperfections of information. The proposed revisions would have improved the quality of information. To be sure, some firms' economic prospects might have looked worse as a result, and its stock market price might have fallen as a result--as well it should. It was inevitable that a day of reckoning would come. Providing misleading information only delayed the day of reckoning, but worse, it led to a misallocation of resources, as overinflated stock prices led to the excessive investment which is at the root of the economic downturn.

Some contend that it is difficult to obtain an accurate measure of the value of the options. But this much is clear: zero, the implicit value assigned under current arrangements, is clearly wrong. And leaving it to footnotes, to be sorted out by investors, is not an adequate response, as the Enron case has brought home so clearly. At the Council of Economic Advisers, we devised a formula that represented a far more accurate lower bound estimate of the value of the options than zero. Moreover, many firms use formulae for their own purposes, in valuing stock options (charging them against particular divisions of the firm). However, Treasury, in its opposition to the FASB concerns, was singularly uninterested in these alternatives. I leave it to others to hypothesize why that might have been the case.

If we are to have a stock market in which investors are to have confidence, if we are to have a stock market which avoids the kind of massive misallocation of resources that result when information provided does not accurately report the true condition of firms, we must have accounting and regulatory frameworks that address these issues. As derivatives and other techniques of financial engineering become more common, these problems too will become more pervasive. While headlines and journalistic accounts describe some of the inequities--those who have seen their pensions disappear as corporate executives have stashed away millions for themselves--what is also at stake is the long run well being of our economy. The problems of Enron and Global Crossing are part and parcel of the current downturn.

Warren Buffett, Opinion in the Washington Post
Stock Options and Common Sense
April 9, 2002:

In 1994 seven slim accounting experts, all intelligent and experienced, unanimously decided that stock options granted to a company's employees were a corporate expense. Six fat CPAs, with similar credentials, unanimously declared these grants were no such thing.

Can it really be that girth, rather than intellect, determines one's accounting principles? Yes indeed, in this case. Obesity–of a monetary sort—almost certainly explained the split vote.

The seven proponents of expense recognition were the members of the Financial Accounting Standards Board, who earned $313,000 annually. Their six adversaries were the managing partners of the (then) Big Six accounting firms, who were raking in multiples of the pay received by their public-interest brethren.

In this duel the Big Six were prodded by corporate CEOs, who fought ferociously to bury the huge and growing cost of options, in order to keep their reported earnings artificially high. And in the pre-Enron world of client-influenced accounting, their auditors were only too happy to lend their support.

The members of Congress decided to adjudicate the fight -- who, after all, could be better equipped to evaluate accounting standards? -- and then watched as corporate CEOs and their auditors stormed the Capitol. These forces simply blew away the opposition. By an 88-9 vote, U.S. senators made a number of their largest campaign contributors ecstatic by declaring option grants to be expense-free. Darwin could have foreseen this result: It was survival of the fattest.

The argument, it should be emphasized, was not about the use of options. Companies could then, as now, compensate employees in any manner they wished. They could use cash, cars, trips to Hawaii or options as rewards—whatever they felt would be most effective in motivating employees.

But those other forms of compensation had to be recorded as an expense, whereas options -- which were, and still are, awarded in wildly disproportionate amounts to the top dogs -- simply weren't counted.

The CEOs wanting to keep it that way put forth several arguments. One was that options are hard to value. That is nonsense: I've bought and sold options for 40 years and know their pricing to be highly sophisticated. It's far more problematic to calculate the useful life of machinery, a difficulty that makes the annual depreciation charge merely a guess. No one, however, argues that this imprecision does away with a company's need to record depreciation expense. Likewise, pension expense in corporate America is calculated under wildly varying assumptions, and CPAs regularly allow whatever assumption management picks.

Believe me, CEOs know what their option grants are worth. That's why they fight for them.

It's also argued that options should not lead to a corporate expense being recorded because they do not involve a cash outlay by the company. But neither do grants of restricted stock cause cash to be disbursed—and yet the value of such grants is routinely expensed.

Furthermore, there is a hidden, but very real, cash cost to a company when it issues options. If my company, Berkshire, were to give me a 10-year option on 1,000 shares of A stock at today's market price, it would be compensating me with an asset that has a cash value of at least $20 million -- an amount the company could receive today if it sold a similar option in the marketplace. Giving an employee something that alternatively could be sold for hard cash has the same consequences for a company as giving him cash. Incidentally, the day an employee receives an option, he can engage in various market maneuvers that will deliver him immediate cash, even if the market price of his company's stock is below the option's exercise price.

Finally, those against expensing of options advance what I would call the "useful fairy-tale" argument. They say that because the country needs young, innovative companies, many of which are large issuers of options, it would harm the national interest to call option compensation an expense and thereby penalize the "earnings" of these budding enterprises.

Why, then, require cash compensation to be recorded as an expense given that it, too, penalizes earnings of young, promising companies? Indeed, why not have these companies issue options in place of cash for utility and rent payments—and then pretend that these expenses, as well, don't exist? Berkshire will be happy to receive options in lieu of cash for many of the goods and services that we sell corporate America.

At Berkshire we frequently buy companies that awarded options to their employees—and then we do away with the option program. When such a company is negotiating a sale to us, its management rightly expects us to proffer a new performance-based cash program to substitute for the option compensation being lost. These managers—and we—have no trouble calculating the cost to the company of the vanishing program. And in making the substitution, of course, we take on a substantial expense, even though the company that was acquired had never recorded a cost for its option program.

Companies tell their shareholders that options do more to attract, retain and motivate employees than does cash. I believe that's often true. These companies should keep issuing options. But they also should account for this expense just like any other.

A number of senators, led by Carl Levin and John McCain, are now revisiting the subject of properly accounting for options. They believe that American businesses, large or small, can stand honest reporting, and that after Enron-Andersen, no less will do.

I think it is normally unwise for Congress to meddle with accounting standards. In this case, though, Congress fathered an improper standard—and I cheer its return to the crime scene.

This time Congress should listen to the slim accountants. The logic behind their thinking is simple:

1) If options aren't a form of compensation, what are they?
2) If compensation isn't an expense, what is it?
3) And if expenses shouldn't go into the calculation of earnings, where in the world should they go?

Stephen Barr, Senior Contributing Editor of CFO Magazine
Letter to the Editor of the New York Times
April 5, 2002:

Re "Leave Options Alone" (Op-Ed, April 5), by John Doerr and Frederick W. Smith: What if, in the mid-1990's, accounting-rule makers had not caved in to lobbyists and instead had forced companies to recognize options as a compensation expense on financial statements?

There would still have been a technology boom, a bear market and a period of recession. Such cycles are immutable. But there may have been less of the accounting gamesmanship that is now the object of government investigation and investor ire.

Options should count as an expense to the corporation, and the ability to exercise them should be based on stock performance that exceeds an index of peers.

THE CONFERENCE BOARD

Testimony
Dr. Carolyn Kay Brancato
Director, Global Corporate Governance Research Center
The Conference Board

Before
Senate Finance Committee
April 18, 2002

I would like to thank the Committee for the opportunity to discuss The Conference Board's program on Corporate Governance Best Practices. After having spent eight years at The Congressional Research Service, as head of the Industry Analysis and Finance Section of the Economics Division, it is a pleasure to return to Capitol Hill today.

I first started analyzing corporate governance issues at CRS during the "takeover wars" of the early 1980s.[1] Then, in 1987, I co-founded, along with Ira M. Millstein and others, the Columbia Law School Institutional Investor Project, where I devised the methodology widely used today for tracking U.S. institutional investor assets, equity holdings and turnover and trading patterns. Subsequently, I founded The Global Corporate Governance Research Center after I arrived at The Conference Board in 1993.

The Conference Board's Global Governance Research Center is, to ensure objectivity, comprised of both major global corporations and institutional investors who gather together for seminars and to sponsor and oversee our research program (see Appendix 1 for a description of the Center and its research).

The Conference Board is a not-for-profit business membership organization, founded in 1916 to enhance the role of business in society. We now have more than 3,000 members in more than 62 countries of the world. We are non-advocacy and share "best practices;" therefore, do not make recommendations for or against any legislative proposal. At our Governance Center, we work extensively with companies on corporate governance matters and, in conducting our work, we hold confidential meetings, briefings and research interviews. If we wish to quote any company or executive, we must obtain written clearance permission; therefore, I am not at liberty today to refer to any corporation or executive unless they have participated in our research/clearance process.

I am, however, pleased to respond to the committee's request for an overview of:

1. the responsibilities and skills required of corporate directors;
2. board processes to ensure board effectiveness with special attention to methods directors can use to monitor corporate performance;
3. issues confronting directors who are obviously not full time with a company yet must "monitor" and "oversee" company activities.

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[1] While at the Congressional Research Service, I authored numerous CRS and committee prints on Greenmail, Mergers & Acquisitions, Leveraged Buyouts, Junk Bonds, Institutional Investors, etc.

Enron: A Sea Change in Corporate Governance

Before examining the responsibilities, skills and board processes, a word about Enron is appropriate. I believe that, when the debate is concluded, the Enron bankruptcy will be seen as having caused a sea change in corporate governance generally and in how directors view their roles specifically. To this end, The Conference Board is undertaking a major Director/Senior Executive Roundtable project, with meetings to be held at Stanford Law School and the University of Delaware's Center for Corporate Governance which will invite input from the Delaware Chancery and Supreme Courts. The final meeting for this project will be held at TIAA-CREF (see Appendix 2).

We define "corporate governance" as a system of checks and balances between the board, management and investors to produce an efficiently functioning corporation, ideally geared to produce long-term value. Our global research at The Conference Board leads us to conclude that corporate governance models do not vary by country, e.g. there is no one "U.S." model of corporate governance compared to an "Asian" model, or a "European" model. Governance systems are largely determined by the ownership structure of the company, regardless of its global geographic location. Moreover, "best practice" elements, such as the number of "independent" directors, will vary depending on certain key ownership structures such as:

- Companies with widely held and dispersed shareholders;
- Companies which are closely held by blocks of investors;
- Companies which are family-owned businesses; and
- Newly privatized businesses where the government retains a residual investment.

Although each country's regulatory and corporate law system will shape the specifics of its corporate governance, our research finds a trend towards general convergence in global governance standards reflecting the following general principles:

- Director independence and effective oversight;
- Accountability to shareholders;
- Transparency and disclosure; and
- Protection of minority shareholder rights.

Thus, the Committee's focus on director responsibilities is central not just to U.S. governance but to global governance developments as well.

Corporate governance, as we think of it today, unfortunately started in an adversarial vein. Its first stage was prompted by attempts on the part of certain companies in the early 1980s to pay "greenmail" to get raiders to withdraw their hostile takeover bids. This raised concern on the part of large institutional investors such as the California Public Employees' Retirement System (CalPERS) that management was acting in its own behalf rather than for the benefit of shareholders. Numerous proxy voting efforts ensued as activist public pension funds used the proxy to sway public opinion and to attempt to influence management. A second wave of governance activism occurred during the late 1980s when individual investors such as CalPERS and the New York State Common Retirement Fund made more direct contact with management. They asked companies such as General Motors to provide information on specific board processes such as CEO succession.

Having used the proxy as a surrogate measure to try to improve board effectiveness, these investors now went straight to management with varying success. Certain companies did formulate corporate governance guidelines, and investors produced a "report card" on their efforts. But governance, as it developed throughout the 1990s, still tended to be generally more in response to external pressures than as a means company managements and boards universally saw would lead to improvements in their internal processes. External pressures included:

- Dialogue, media and voting pressures from investors;
- Pressures from the SEC requiring more disclosure especially in the area of executive compensation;
- Pressures from stock exchanges amending their listing requirements especially with regard to audit committees procedures and definitions of independence;
- Legislative pressures such as changes in the IRS code provisions 162(m) limiting the deductibility of executive compensation; and
- Pressures from the courts, especially those in Delaware, forcing directors to look more carefully at their roles.

It is fair to say, however, that many boards have begun to embrace good governance, although the collegial format that is the basis for board interaction tends to discourage open disagreement. Change therefore tends to come either if there is an individual director/CEO/senior executive who is a corporate governance champion or if there is a crisis. With Enron, I believe that companies are no longer looking upon corporate governance as something thrust upon them from the outside. In every boardroom around the country, directors are asking themselves questions such as:

- What processes do we need to put in place to make us more aware of "red flags" in company operations?
- How do we fulfill our monitoring role and yet rely on management and external accountants?
- How can corporate governance processes be used to help keep our company viable and restore public confidence in our accounting, lines of business, etc.?
- How will instituting corporate governance best practices reduce corporate risk?

Thus, corporate governance has finally moved from an external imposition to something boards can not afford to dismiss if they want to provide internal efficiencies in running the corporation and if they want properly to manage risk.

A. The Responsibilities and Skills Required of Directors

Corporate governance best practices are based on two basic legal requirements that shape director actions:

(1) **the duty of care** to be informed and exercise appropriate diligence in making decisions and to oversee the management of the corporation; and
(2) **the duty of loyalty** to put the interests of the corporation before those of the individual director.

According to the American Bar Association, the board's responsibilities include:

- reviewing and monitoring fundamental operating, financial and other corporate plans, strategies and objectives;
- selecting, regularly evaluating and fixing the compensation of the chief executive officer ("CEO") and the most senior executives;
- developing, approving and implementing succession plans for the CEO and the most senior executives;
- evaluating the performance of the corporation and its most senior management and taking action, including changing corporate plans, strategies and objectives and replacing management, when appropriate;
- adopting policies of corporate conduct and monitoring compliance with those policies and with applicable laws and regulations, as well as the adequacy of accounting, financial and other internal controls;
- reviewing the process of providing appropriate financial and operational information to decision makers (including board members) and shareholders; and
- evaluating the overall effectiveness of the board and its composition.[2]

The ABA Guidebook notes that, to be effective, a director should become familiar with the corporation's business to acquire sufficient knowledge to enable him/her to make an independent evaluation of corporate and senior management performance. This will allow the director to join with other directors to make changes and to challenge, support and reward management as warranted. Accordingly, a director should have a basic understanding of:

- the principal operational, financial and other plans, strategies and objectives of the corporation;
- the results of operations and financial condition of the corporation and its significant business segments for recent periods; and
- the relative standing of the corporation's significant business segments vis-à-vis competitors.[3]

The Conference Board has done considerable research into how boards work and has produced a practical Handbook, *Determining Board Effectiveness: A Handbook for Directors and Officers.* This Handbook has been used by numerous boards to facilitate discussion of their best practices and serves as the basis for a 10 step program on Board Effectiveness described in the next section of this testimony.

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[2] Section of Business Law, American Bar Association, Committee of Corporate Laws, *Corporate Director's Guidebook,* 3rd, 2001, p. 4.

[3] ABA Guidebook, p. 5.

Boardroom dynamics are difficult to prescribe, as groups of people gather together to make informed decisions about the direction of the company. The level of knowledge, integrity and independence necessary to carry out the functions of director are difficult to summarize, but, based on our case study approach, The Conference Board Handbook describes the "behavioral" characteristics of a good director as follows:

- asks the hard questions
- works well with others
- has industry awareness
- provides valuable input
- is available when needed
- is alert and inquisitive
- has business knowledge
- contributes to committee work
- attends meetings
- speaks out appropriately at board meetings
- prepares for meetings
- makes long-range planning contribution
- provides overall contribution

B. Effective Board Processes

In defining a system of board practices that leads to board effectiveness, the Conference Board's Handbook makes clear that:

> **Instituting governance best practices will provide the company with an INTERNAL effectiveness structure and a tool to manage corporate risk.**
> **The key to accomplishing this is to make certain that the company's board is managed as well as the company itself is managed.**

Each board will be run differently according to the company's stage of development, ownership structure, size, mix, composition and personalities of the board. The "one size doesn't fit all" rule clearly applies. On the other hand, there are basic legal requirements as noted above, as well as "management" skills which boards can and should adopt no matter its configuration. The Handbook poses fundamental questions boards should ask themselves:

- Is our board managed as well as our company is managed?
- Does our board have the strengths it needs to achieve our strategic goals?
- How well does our board track our company's success in reaching goals?

In undertaking an assessment of their effectiveness, boards should collaborate, with input from management, to respond to the 10 questions that follow.

1) How Does Your Board Define Its Role and Duties? Prioritize Its Responsibilities?

- agree on the role of the board versus the role of management
- vary specifics of board's role with size, stage and strategy of company and talents and personalities of CEO and board
- discuss role of the board in monitoring strategy openly and regularly with CEO and in executive board session
- focus on oversight not micromanagement
- spend one "retreat" session per year on strategic oversight
- focus on creating long-term value

2) Does Your Board Have Sufficient "Independence" To Perform Its Duties?

- independence leads to objectivity in monitoring management
- notwithstanding definitions of "independence" by stock exchanges on paper, in reality, independence means the ability to ask the hard questions
- directors should exercise independence in reviewing actions by auditors & compensation consultants even if they are initially chosen by management
- all external experts such as auditors and compensation consultants should know that, on matters pertaining to the board, they are responsible to the board

3) Does Your Board Have the Right Size and Structure?

- tailor size of the board to the needs of the company and its stage of development
- tailor people to company goals
- develop board committee structure to best suit underlying responsibilities
- revise board committee structure as needed -- in addition to usual audit and compensation committees, some companies combine nominating committee with new corporate governance committee
- while some decisions should be taken by full board, but where committees are used, ensure that committees appropriately report to full board
- board has authority to hire experts and investigate any management activities it believes are required to fulfill board's duty of care

4) How Does Your Board Oversee Auditing And Compliance To Minimize Risk?

- ensure independent directors on audit committee with appropriate financial literacy and knowledge to ask the hard questions
- ensure audit committee charter is current
- board has responsibility to hire auditors, despite the fact that they interact extensively with management
- following the landmark Caremark decision[4], directors have affirmative requirement to ensure compliance personnel and program are in place
- external auditors should not be same as internal auditors
- board should have access to external/internal audit with management not present and should determine if there are any accounting issues which are questionable
- examine company practices with regard to whether auditors can/should perform other consulting services such as providing information technology services
- examine practices relating to whether external auditors should be rotated; examine hiring policies for "alumni" auditors
- affirm ethics program and ensure it is not suspended
- review related party transaction policies and ensure compliance among board and management to comply with duty of loyalty

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[4] According to noted legal scholar, Charles M. Elson, the board's role in ensuring corporate compliance with applicable law has expanded significantly in the past few years. The Delaware Court of Chancery, in its now infamous 1963 ruling in *Graham v. Allis-Chalmers Manufacturing Co.* [188 A.2d 125 (Del. 1963)], confirmed the traditional view that the board of a large enterprise was merely a policy-making entity and had no legal duty to enact a legal compliance program in the absence of certain warning signals. Today, the board's responsibilities in this respect are viewed entirely differently.

Boards that fail to establish effective corporate compliance procedures may face substantial liability. Two important factors are now causing boards to act prophylatically to ensure corporate legal probity:

- the creation of the federal Organizational Sentencing Guidelines, which impose more lenient treatment on companies having compliance manuals and programs; and more importantly

- the Delaware Chancery Court's landmark 1996 ruling in *Caremark International Inc.*, which imposes an affirmative duty on the board to create a compliance mechanism.

In *Caremark*, Chancellor William Allen essentially overruled *Graham*, holding that a board, as part of its duty of care, has an obligation to "exercise a good faith judgement that the corporation's information and reporting system is, in concept and design, adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations." As the eminent corporate commentator, Charles Hansen, has pointed out, the facts of *Caremark* suggest that some form of "information gathering and reporting system be established at a very minimum. (See decision in re Caremark International Inc. Derivative Litigation, Civ A .No. 13, 670, 1996 WL 549894, at #8 (Del. Ch. Sept. 25, 1996)).

5) How Effectively Does Your Board Monitor Company Performance?

- measure strategic activities (such as quality, intellectual capital, customer satisfaction) which matter to the success of the company
- certain new metrics may have to be created, but most companies are already collecting about 70 percent of the data they require to track strategic performance measures
- strategic measures can be tangible and intangible
- agreement among boards, management and on-line personnel as to which measures track the strategic success of the company is just as important as which measures are actually chosen
- measures should be appropriate for level of oversight - board gets important "dashboard" indicators - managers get more detailed measures

Note: Appendix 3 describes The Conference Board's computerized "Dashboard" to track strategic performance measures. The dashboard, much like the dashboard on a car, provides key measures which enable the driver to know if he is likely to get to his destination. They are not like financial reporting, which is rather like looking in the rear view mirror. A board will have perhaps only the top 5 measures to track and see if they are in the target range or below it. Managers will "drill down" into the measures and how they are tracked throughout the company.

Strategic performance measures can provide an alternative to stock based compensation, as managers might be rewarded for quality improvements, or for reducing environmental impact and increasing compliance with health and safety requirements.

Strategic performance measures may also provide "red flag" warnings when critical success factors are out of alignment. Some of these measures move from being operational to being strategically important to the viability of the company. For instance, warrantee data on certain types of tires as they are installed on certain types of vehicles, may rise above operational information to become an issue for the board relating to corporate reputation and viability.

Finally, a Conference Board survey of 113 major global corporations concludes that, when companies institute strategic performance measurement (SPM) systems, they tend to outperform their peers in stock valuation.

6) How Does Your Board Conduct The CEO Appointment And Succession Planning Process?

- hiring the CEO is the primary function of the board
- CEO succession is a primary responsibility of the board and should be a continuous process driven and controlled by the board with CEO input
- develop succession requirements from corporate strategy
- find right leader at right time
- continuously build/develop talent pool
- avoid "horse race" which leads to loss of key deputies when new CEO chosen

7) How Does Your Board Best Structure And Utilize Its Nominating Committee?

- choose only independent members
- write a charter and director selection criteria
- review skill set of whole board against strategic needs and fill gaps
- remove the "blinders" in director candidate pool
- build an independent team with a diversity of backgrounds, skills and perspectives
- professional advice can be useful to widen the pool and affirm independence
- know when to involve the CEO
- provide formal and informal orientation for new directors

8) What Is Your Board's Role In Determining Director And Executive Compensation?

- compensation committee should be entirely independent directors without CEO
- in using external advisers such as compensation consultants, they should know that they report to the board, not to management
- compensation committees should become much more involved in the strategy of the company because of option dilution and the fact that compensation is increasingly related to capital formation
- boards should be briefed on new compensation techniques, perhaps by outside experts, although companies should make effective use of internal human resources department
- director equity compensation/executive equity compensation must be reviewed in light of new developments in compensation practices
- review stock options to ensure they provide proper incentives and avoid excessive dilution
- consider strategic performance measures rather than just options in compensation packages

Note: The Conference Board recently completed a report on The Compensation Committee of the Board (see Appendix 1) which delves into the changing responsibilities of the committee and how it can deal with external compensation consultants.

9) Does Your Board Have A Process to Evaluate Whether It Is Achieving Its Goals?

- start by discussing strategy and focus the entire board on the following question: can the board help the company achieve its strategy?
- at first do it collectively not individually

    - make it collegial
    - make it confidential

    To lead the process:
    - consider Chairman
    - consider head of nominating committee
    - consider general counsel or governance officer

- 90% of companies that evaluate their boards say the process makes their boards more productive ...

10) What Are Your Top 10 Best Practice and Red Flag Processes?

Based on data provided by the American Society of Corporate Secretaries two tables are constructed below. The first is the ASCS compilation of the most common board practices; the second is The Conference Board's assessment of the most frequent "red flag" practices.

Top 10 Board Practices

Rank and % companies adopting

1. Charter for Audit Committee - 97
2. Agenda item background information routinely distributed in advance of meetings - 95
3. Outside directors free to provide input to agenda - 90
4. Directors have access to management below CEO level - 88
5. Directors' compensation includes stock/stock options - 82
6. Director comp variable, dependent on meeting attendance - 79
7. Independence standard applied to screen outside directors - 79
8. Periodic board meetings devoted to overall company strategy - 74
9. Board/committee appoints committees and chairmen - 74
10. Nominating Committee plays a dominant role in the screening and selection of director candidates - 73

Top 10 "Red Flag: Board Practices

Rank and % companies adopting

1. Job description for Chairman or CEO only 50% adopting
2. Written guidelines on corporate governance - 44
3. No director with significant business sit on compensation committee - 40
4. Skills matrix to assess board composition and fill gaps when selecting new directors - 39
5. Written criteria for director selection - 37
6. No employee/former employee sit on nominating committee - 35
7. Regular meetings without CEO and management present to discuss issues other than CEO compensation - 33
8. Compensation committee charter - 30
9. No director with significant business sit on nominating committee - 24
10. Nominating/Governance committee charter - 10

C. Director Ability to Fulfill Responsibilities

While board members should be knowledgeable, and base their actions on duties of care and loyalty, some commentators have expressed concern that directors can not possibly exercise all that is required of them. In addition, some express concern that new director candidates will decline taking positions on boards in a new atmosphere of liability.

The ABA notes, however, that directors have the right to rely on others in exercising their duties:

> In discharging board or committee duties, a director is entitled to rely (absent knowledge that would make the reliance unwarranted) on management or board committees performing their delegated responsibilities. A director is also entitled to rely (absent knowledge that would make the reliance unwarranted) on reports, opinions, information and statements, including financial statements and other financial data, presented by (i) the corporation's officers or employees whom the director reasonably believes to be reliable and competent in the matters presented, (ii) legal counsel, public accountants or other persons as to matters that the director reasonably believes to be within their professional or expert competence or as to which the person otherwise merits confidence and (iii) committees of the board on which the director does not serve. A director who relies on others, however, has a responsibility to keep informed of the efforts of those to whom work has been delegated. The extent of this review function will vary depending upon the nature and importance of the matter in question.[5]

Finally, the ABA notes that directors should make inquiry into potential problems or issues when alerted by circumstances or events that indicate that board attention is appropriate.

[5] ABA Guidebook, p. 9.

APPENDIX 1

The Conference Board's Global Corporate Governance Research Center provides a unique opportunity for senior corporate executives and institutional investors to network in small, highly interactive, and non-adversarial settings. Together, these groups meet to advance cutting edge governance practices and participate proactively in landmark research on corporate governance issues. The Center's objective is to assist corporations to enhance their governance processes and thereby inspire confidence and facilitate capital formation in today's globally competitive marketplace.

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Institute of Directors (Belgium)
Norsk Hydro ASA (Norway)
Novartis International AG (Switzerland)
Powergen Plc. (UK)
Rabobank (The Netherlands)
Zurich Financial Services (Switzerland)

Affiliates and Host Organizations

American Society of Corporate Secretaries ASCS
Association of British Insurers
Australian Institute of Company Directors
Commonwealth Association for Corporate Governance
German Society of Investment Analysts and Portfolio Managers DVFA
The Institute of Chartered Accountants (in England & Wales)
Institute of Chartered Secretaries and Administrators ICSA (UK)
Investor Responsibility Research Center IRRC
National Association of Corporate Directors NACD
The National Association of Pension Funds NAPF (UK)
Pensions Investment Research Consultants Ltd. PIRC (UK)
The Royal Society for encouragement of Arts, Manufactures & Commerce RSA (UK)
The Swedish Corporate Governance Forum

Chief Governance Officers

American International Group, Inc.
Arch Chemicals, Inc.
Avon Products, Inc.
BP p.l.c. (UK)
Bunge Limited
Computer Associates International, Inc.
CSX Corporation
Curtiss-Wright Corporation
Dana Corporation
Heidrick & Struggles International, Inc.
J.P. Morgan Chase & Company
Merrill Lynch & Co., Inc.
The Gillette Company
UtiliCorp United, Inc.

APPENDIX 1 (continued)

Research Program

Published Reports

The Compensation Committee of The Board: Best Practices For Establishing Executive Compensation	Report 1306-01-RR, 2001
Top Executive Compensation in 2000	Report 1305-01-RR, 2001
Directors' Compensation and Board Practices in 2001	Report 1304-01-RR, 2001
The Global Investor and Corporate Governance: What Do Institutional Investors Want?	Report 1297-01-RR, 2001
Corporate Governance: Global Trends Examined from an Asian Perspective	Special Report 00-2, 2000
Debating European Corporate Governance Issues	Special Report 00-1, 2000
Top Executive Compensation in 1999	Report 1281-00-RR, 2000
Directors' Compensation and Board Practices in 2000	Report 1280-00-RR, 2000
The Link Between Corporate Governance and Corporate Performance: Year 2000 Update	Report 1276-00-RR, 2000
Corporate Governance and Cross-Border Mergers	Report 1273-00-RR, 2000
Determining Board Effectiveness: A Handbook for Directors and Officers	Special Report 99-1, 1999
Aligning Strategic Performance Measures and Results	Report 1261-99-RR, 1999
Directors' Compensation and Board Practices in 1999	Report 1259-99-RR, 1999
Aligning Performance Measures and Incentives in European Companies	Report 1252-99-RR, 1999
Top Executive Compensation: Canada, France, the U.K., and the U.S.	Report 1250-99-RR, 1999
Globalizing the Board of Directors: Trends and Strategies	Report 1242-99-RR, 1999
Board Diversity in U.S. Corporations: Best Practices for Broadening the Profile of Corporate Boards	Report 1230-99-RR, 1999
The Link Between Corporate Governance and Performance	Report 1215-98-RR, 1998
Top Executive Compensation in 1998	Report 1227-98-RR, 1998
Institutional Investors and Corporate Governance	Irwin Publishing, 1997
Communicating Corporate Performance: A Delicate Balance	Report 1188-97-RR, 1997
The Corporate Board: A Growing Role in Strategic Assessment	Report 1152-96-RR, 1996
The Globalization of U.S. Institutional Investor Activism	White Paper WP-17, 1996
Directors' Retirement Benefits	Report 1161-96-RR, 1996
Corporate Boards: CEO Selection, Evaluation and Succession	Report 1103-95-RR, 1995
New Corporate Performance Measures	Report 1118-95-RR, 1995

Report Series

The Conference Board Institutional Investment Report, 3 issues per year

Issue 1: Financial Assets and Equity Holdings

Issue 2: Turnover, Investment Strategies, and Ownership Patterns

Issue 3: International Patterns of Institutional Investment

Upcoming Research Reports

Gaining Investor Confidence in India Corporates: A Handbook for Directors and Officers of Corporations in India

Gaining Investor Confidence: A Handbook for Directors and Officers of Corporations in Hong Kong

Gaining Investor Confidence: A Handbook for Directors and Officers of Corporations in Singapore

APPENDIX 2

Conference Board New Project

Director/Senior Executive Roundtable Project

Post Enron Post Mortem: Developing A Blueprint for Best Corporate Governance Practices and Early Warning Systems

Featuring Three Components:

1) **Roundtables: Directors and Senior Executives will meet in a series of Roundtables throughout the country to identify best practice improvements in corporate governance in the wake of the Enron situation.**

Participating companies can send any of their Directors and/or Senior Executives to any or all of the six Roundtable sessions:

#1	Thurs., June 13	Inaugural session at The Conference Board	New York City
#2	July (TBD)		Washington, DC
#3	Wed., July 31	Stanford Law School	Stanford, CA
#4	Sept. (TBD)	The University of Delaware's Center for Corporate Governance *	Newark, DE
#5	Sept./Oct. (TBD)		Chicago
#6	Wed., Oct. 30	Final Session -- at TIAA-CREF To be held in conjunction with the Annual Fall Symposium of the Global Corporate Governance Research Center	New York City

* At Roundtable #4, Charles M. Elson, Professor of Corporate Governance at the University of Delaware, will invite input from the chancellors and justices of the Delaware Chancery and Supreme Courts.

2) **Research: Focus groups and research will supplement the roundtables to produce several products:**

- A *Best Practice Blueprint* to be produced in a final report in Fall 2002
- An on-going inventory of practice and procedural changes participating companies are instituting in response to the Enron situation.
- White-paper *Executive Action Alerts* produced as the project progresses, to flag key issues in the accounting, compliance and insurance areas.

3) **Private Briefings: If Directors and/or Senior Executives are not able to attend any of the Roundtables, or if companies wish private briefings for their Directors and/or Executives during the course of the project, these can be arranged for a fee to cover time and travel.**

Background: The "Enron effect" has reduced public confidence in corporations generally and has lead to stock price erosion, even among some leading blue-chip companies. This failure of investor confidence poses a significant threat -- not only to companies with complex corporate accounting but to the whole corporate sector.

At the same time, developing case law has put greater burdens on Corporate Directors to be proactive. Directors are no longer given wide protections under the business judgment rule; rather, they must be proactive to ensure compliance programs and to question management if "red flags" arise or if they, as Directors, should reasonably have known that such "red flags" would lead to uncovering problems.

Many of the classic corporate disasters have occurred at companies where the trappings of good corporate governance seemed to be in place. They had outside "independent" Directors -- Directors who owned stock and therefore, in theory, had interests aligned with shareholders. By all external measures, they had active and "professionally-run" audit committees and compensation committees of the Board. Although the specifics of some of these classic corporate disasters are useful to examine for their corporate governance lessons, future corporate crises will inevitably take many new and varied forms. Corporate Directors and Senior Executives should address the fundamental issues detailed below to minimize the risk of a future crisis – *whatever form it takes.*

Oversight

- What are a Director's "red flags"? How can Directors be expected to know when something is wrong?
- What control processes does the Board institute to ensure it is effectively performing its oversight role generally and in key areas, such as overseeing the strategic direction of the company?

Auditing

- What is the responsibility of the Board with regard to auditing oversight? How well does the Board monitor the integrity of the financials?
- How can the Board and Management enhance audit committee practices to ensure credibility?
- How should companies handle rotation of auditors and the appointment of internal and external auditors?
- What is the relationship between an auditor's audit and consulting practices? What oversight does the Board have to ensure objectivity with respect to the audit?

Disclosure

- Does the company need to increase its level of transparency and disclosure? If so, how?
- Does the Board have procedures to review and disclose any special financial transactions and related party transactions?

Compliance and Ethics

- Do the Board and Management have an effective system to track and monitor compliance in all the necessary and expanding areas?
- What processes and procedures do the Board and Management have in place to deal with ethics issues?
- How can companies work to reduce conflicts of interest with external constituents, such as investment banks and legal and financial service providers?

Liability

- How are the boundaries shifting with regard to what Directors are expected to know about, have fiduciary control over, and be held liable for?
- What issues are facing the Director & Officer (D&O) insurance industry with regard to the protection of Directors?
- How is the shifting legal and insurance climate affecting the ability or willingness of outside Directors to serve on Boards?

Board Management Processes

- How does the Board define and ensure Director independence?
- Does the Board have an effective structure? Does it make effective use of such committees as audit, compensation, nomination and/or corporate governance?
- Has the Board developed key measures of its own management processes and success as a Board?

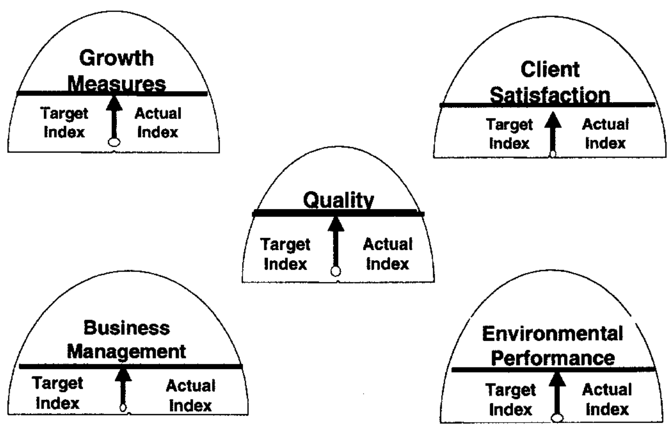
Communications

- How are Boards and Management reviewing their processes of communications to employees, shareholders and the public at large?

Note: The Conference Board Governance Center programs are ISS approved Director educational programs that provide ISS corporate governance ranking credit for companies whose Directors attend.

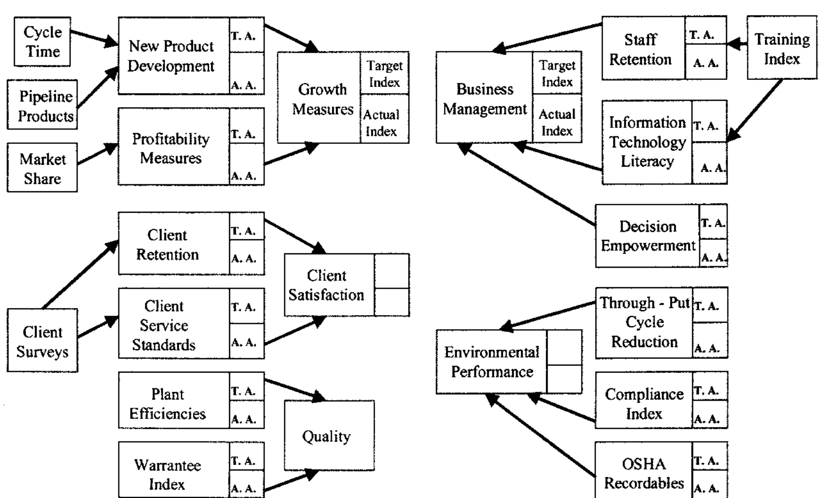
APPENDIX 3

The Conference Board's "Dashboard" of Strategic Performance Measures



Source: Global Corporate Governance Research Center

Computerized "Dashboard" To Track Strategic Measures



Source: Global Corporate Governance Research center

United States Senate

WASHINGTON, DC 20510-5004

Senator Mike Enzi
Statement On Stock Options
Before the Finance Committee
April 18, 2001

Mr. Chairman, thank you for this opportunity to come before this committee to speak on the subject of executive compensation through stock options. In the wake of the collapse of Enron, I appreciate the concerns members have with the issue of stock options.

As we all know, many of Enron's executives and employees were issued stock options. In the months preceding Enron's bankruptcy, executives who were aware of the true condition which the company was in, exercised millions of dollars of their options. Now, thousands of Enron employees, who were kept in the dark on the company's finances, are left with worthless Enron stock and shattered retirement savings.

I appreciate Members' efforts to try to fix problems posed by Enron. In addition, we shouldn't lump the dot com companies with what happened at Enron. Congress must react to what happened at Enron, but we must be careful not to overreact. While I think legislation may be an appropriate means to ensure employees are protected and prevent future Enrons, we should not do anything to hamper employees from receiving stock in their company. When properly used, stock options can be a marvelous opportunity for employees.

I understand Federal Reserve Chairman Alan Greenspan supports the legislation Senator Levin has put forward because he believes stock options should be treated as compensation. And I agree with him that stock options may, at some point in the future become compensation, but we disagree at when that point is. We must be sure that whatever is done, employees, small businesses, and startup companies are protected. I want those companies to continue to have an incentive to issue options, and employees to have the opportunity to receive them.

Let me explain what as I see as some of the problems with the legislation and what some of the solutions should be. First, it is important to note that the same debate over expensing stock options on company financial statements occurred a few years ago. Some of the same arguments for and against it were debated back then. The solution was to give companies the option of listing the number of stock options issued by a company in a footnote to the financial sheets, or directly on its income or financial statements as an expense. That way investors and employees have the ability to see how much stock was outstanding before they invested in the company or exercised their stock options.

If this legislation was enacted, fewer employees will receive stock options. Instead of employees on all income levels receiving the rewards options offer, only high level executives will reap the benefits. Regardless of what Congress does on this issue, these companies are not going to cease offering CEOs and senior executives this form of compensation. It's just not going to happen. Companies will pay whatever they have to pay in order to get the very best talent at the top levels of the company. If the options become more expensive for the company to offer, which is what the Levin legislation accomplishes, rank-and-file employees will lose an instrumental tool they utilize to develop wealth.

This legislation will also have negative consequences on small businesses and start-up companies. The National Commission on Entrepreneurship has reported "that high-growth entrepreneurial companies create roughly two-thirds of all the new jobs in the United States economy, are responsible for at least two-thirds of the innovation in the economy, and account for about two-thirds of the difference in the economic growth rates among industrialized nations." The Commission has further noted that the Levin/McCain legislation will negatively affect "the 30 years of favorable tax and accounting treatment afforded the stock options granted by entrepreneurial companies to their employees."

These small start-up companies cannot afford to offer the salaries larger companies give, so they must offer stock options as an incentive to attract highly-skilled employees. The Commission points out that without stock options household names like Intel, Federal Express, Apple, Dell and Starbuck, would not exist. And under the current law, the employees that take the risk of working for start-up companies have the ability to make much more money than through the traditional method of payment by wages. Again, most employees do not want to lose this monetary opportunity, and start-up companies certainly cannot risk losing the stock option incentive they currently have to attract employees.

We all know that ingenuity and the entrepreneurial spirit have helped make this country great. Small companies and startup businesses have been the backbone of our economy. They have provided economic growth and employment opportunities to small and medium sized communities. We cannot risk discouraging this important trend by placing negative pressure on this already fragile sector of the economy.

Another concern I have with the Levin legislation is that it is so difficult to value stocks at the time options are granted. It is difficult and unfair to require companies to value stock options as an expense for their financial statements when the value cannot be accurately estimated. For instance, many options which were granted over the past several years are now valueless. What's even more distressing is that many of these stock prices will never rise back to the levels they once were. In fact, many of the companies from the Internet boom that offered large options packages are now either delisted or bankrupt. It would have been impossible to properly expense these now worthless options.

Let me also talk briefly about the tax consequences of the Levin legislation. Right now, when stock options are granted or issued there is no tax consequence for either the employer or employee. But when the stock options are exercised, the employee is taxed as if it is ordinary income. The amount is based on the difference between the market price and the exercise price. At the time these stock options are exercised, the employer can then take a deduction in an amount equal to what is considered as ordinary income to the employee. This deduction provides a useful tool for a company to offer options to its employees.

I believe the footnote on issuance of stock options provides sufficient information to investors and employees. Critics who claim this is insufficient underestimate the sophistication of the investing community. Institutional investors and research analysts are able to accurately account the affect the footnote would have on the balance sheet. With this information, average investors can then make educated decisions as to whether to invest in a specific company.

I know issues need to be addressed to reassure the public no future corporate financial catastrophes will occur. However, the problems with these companies won't be fixed with a slight of hand in changing the way in which stock options are expensed or reported. We all know these problems run deeper than that.

What we do need is fuller disclosure and more transparent financial reports. We must require better quality control and enforcement mechanisms for the accounting industry. What may also be needed is shareholder approval for certain stock options for corporate executives and sales transactions. I think any legislation on this issue should make certain employees have some input on how stock options are distributed to company employees. We may also want to look at making sure employee stock options are being issued at the current stock price, rather than issuing company executives stock at significantly reduced rates. These are just a few ideas I believe are worth exploring.

I appreciate this Committee's thoroughness in dealing with this issue. It is important that the Senate should not rush into passing legislation as a knee jerk reaction to what happened with Enron. We need to carefully study what the consequences of any legislation will be. We need to listen to all the parties concerned and weigh all the alternatives.

Again, I appreciate being asked here today, and I appreciate the opportunity to offer my view regarding this issue.

Hearing of the Senate Finance Committee
on
Corporate Governance and Executive Compensation
Thursday, April 18, 2002

Written testimony of Mark G. Heesen
President, National Venture Capital Association

I am Mark Heesen, president of the National Venture Capital Association. NVCA represents more than 475 venture capital and private equity firms throughout the United States. The mission of the association is to foster understanding of the importance of venture capital to the vitality of the U.S. and global economies, to stimulate the flow of equity capital to emerging growth companies by representing the public policy interests of the venture capital and private equity communities at all levels of government, to maintain high professional standards, and to provide research data and professional development for its members.

My comments today reflect the views of NVCA and its members. While NVCA is a member of coalitions devoted to the preservation of stock options for all employees, the views expressed here, per the wishes of this Committee, are those of the venture capital community who often act simultaneously as board directors, investors and shareholders.

Venture funding is a major factor in promoting innovation and entrepreneurial businesses. In the current economic environment, venture investing was down in 2001 and will continue to be down by a considerable amount this year. NVCA expects that the level of investing will return to a more sustainable pace, likely at the then-record levels seen in 1998 and 1999. In any case, venture capital will remain an extremely important and vibrant participant of our economy.

At its core, venture capital is about long-term investing, and its long-term impact is significant. According to a study by DRI-WEFA, attached as Appendix A, venture capital invested during the period 1970-2000 created 7.6 million U.S. jobs and more than $1.3 trillion in revenue as of the end of 2000. The $273.3 billion of venture capital created companies that in the year 2000 alone were responsible for 5.9% of the nation's jobs and 13.1% of U.S. Gross Domestic Product.

It is important to note that, while a majority of venture investing remains in areas of concentrated high tech and biotech activity, the industry is expanding into more and more regions of the country. Vibrant venture communities now exist in areas that, a few short years ago, were not readily associated with the New Economy. We are also pleased to report that venture capital investments were made in 48 states and the District of Columbia last year—a record for our industry.

The growth of the industry throughout the 1990s has been nothing short of extraordinary. To put this in perspective, it is worth noting that in 1995—a record year for the venture industry at that time—only $5.5 billion was invested in some 1,300 companies. Since then, the industry has grown from a relatively small, misunderstood segment of the economy to a national and increasingly international phenomenon that can rightfully claim to be the catalyst behind the high-growth companies driving our economy. In 2000, venture capital funds had nearly $210 billion under management. Also in that year, a record $103.5 billion in new investments were made in more than 5,400 companies. Nearly 3000 of these companies received venture financing for the first time.

NVCA has a vital interest in the subject of this hearing because few aspects of venture investing are more important than attracting and motivating the executive talent needed to manage start-up businesses. Corporate governance, executive compensation and the alignment of the interests of all employees with venture capitalist investors and other shareholders are critical issues for a vibrant venture capital industry.

I. EXCESSES OR MISALIGNMENTS IN EXECUTIVE COMPENSATION SHOULD BE ADDRESSED THROUGH ENHANCED DISCLOSURE AND IMPROVEMENTS IN CORPORATE GOVERNANCE.

I speak for all NVCA members in expressing our deep concern at the enormous losses sustained by Enron's employees and investors as a result of the apparent fraud that led to Enron's collapse. As investors and fiduciaries to other investors, venture capitalists support efforts by the Congress, the Administration, the SEC and the Exchanges to minimize the risk of recurrence. As part of the U.S. capital markets, venture capitalists look forward to working with all policymakers to ensure that our equity markets remain strong and continue to earn the confidence of investors.

At the heart of the Enron scandal was Enron's failure to give accurate and complete information to its shareowners and to the securities markets in general. We support greater transparency in financial statements, therefore, and more current disclosure of material information for all public companies. While no rules will ever eradicate fraud, we support new rules that will make it harder for companies to hide serious problems and significant transactions.

We are pleased that the SEC is working with the securities exchanges, and that the NYSE and NASDAQ are currently reevaluating their corporate governance listing requirements. The Commission and the Exchanges are the best agencies for addressing these governance and disclosure issues with nuance appropriate to these complex and multifaceted issues.

We note that new corporate governance safeguards and shareholder approval of stock option plans that include officers and directors are under consideration. We believe that this is the right kind of effort to restore market confidence and confidence in the integrity of corporate boards. As the use of stock options has spread to a far wider group of companies, the potential for dilution of shareholders has raised appropriate concerns. Again, accountability and disclosure are the keys to addressing these concerns. Therefore, we applaud this approach to greater accountability in granting stock options so that those who bear the true cost of stock options, the shareholders, will have an appropriate check on any risk of self-dealing. A copy of NVCA's letter to Chairman Pitt is Attachment B to this testimony.

Many of these efforts were in motion long before the Enron news broke. Following through on one of Arthur Levitt initiatives, the SEC has substantially enhanced the current disclosure requirements for stock options plans to enhance the transparency of the potential cost of stock option plans to shareholders. The new rules require disclosures of the total number of securities that a company has available for issuance under all of its stock options plans as well as the weighted average exercise price of options, warrants, and rights outstanding under these plans. The tabular disclosure of the dilutive effect of all stock options plans will give investors a fuller picture of the real cost of stock options – potential dilution – and will show to what degree a company's overall options program is subject to shareholder approval.

We also recognize that even the appearance of self-dealing by executives must be avoided. We support substantially accelerated reports of insider transactions, and note that new real-time reports have recently been proposed by the SEC. Through better disclosure and, if needed, greater restrictions, public investors should have full and timely information on the purchase and sale of company stock by insiders. We support proposals to prevent executives from selling shares during lock-down periods when employees are barred from selling their shares. Clearly, we should have equality and fairness in terms of how and when employees at all levels in a company are able to diversify their holdings of company stock.

In a similar vein, NVCA supports tough enforcement against those who game and misuse the system. We have encouraged SEC efforts in a number of areas, for example, we support the use of disgorgement of executive bonuses and other incentive-based forms of compensation in appropriate cases.

As we move to create new rules, it is important to take note of the many rules that already require disclosure and restrict transaction by insiders. Appendix C to my testimony covers most of the current rules that are applicable. Certainly, to the extent that the SEC's enforcement powers need to be enhanced to ensure that wrongdoers are punished, we will fully support such legislation. If the SEC needs more resources to accomplish its mission of protecting investors and promoting capital formation, we support additional funds for that purpose.

In addressing purported Enron concerns, however, we must be cautious toward measures that will not prevent future "Enrons" and will, in fact, cause harm. S. 1940 is such a measure. would force companies into Hobson's choice – take an inaccurate "fair value" expense charge for stock options when options are granted, or forgo any tax deduction when the grantee exercises the options. The likely result in most cases is the death of broad-based stock options plans. We think this result would have devastating consequences – for us as investors, for the companies in which we invest, and for the economy. Stock options are a critical factor in fueling entrepreneurial innovation and economic growth, and they embody a principle that Enron does nothing to diminish: employees should have a financial stake in, and financial responsibility for, the companies they help to build.

II. THE CURRENT TAX TREATMENT OF STOCK OPTIONS IS CONSISTENT WITH SOUND TAX POLICY AND COMMON SENSE.

Neither stock options accounting nor the taxation of options income caused Enron to collapse. Stock options never pose a liability the way Enron's "special purpose entities" and guarantees did. Nor are stock options related to the 401(k) issues that arose at Enron. Enron collapsed for a whole web of reasons including poor management, poor accounting standards, a flawed business plan and a governance breakdown. The tax and accounting treatment of stock options are noise in the background to the real solutions to Enron.

"Non-qualified options," or NQOs fall under Section 83 of the Tax Code, which treats the taxation of stock options in a straightforward and understandable way. When an options grantee (typically an employee or a director) exercises in-the-money options, the grantee taxpayer recognizes ordinary income equal to the difference between the exercise price and the market price on the date of exercise. The grantee includes this income in calculating taxes in that tax year. This treatment is consistent with the general rule that whenever an employee receives something from an employer that has "value" to the employee, it is income unless Congress says otherwise. In the same tax year, the corporation is entitled to a deduction in an amount corresponding to the grantee's income. This treatment is not because the employer has an "expense" but because of the general rule that whenever an employee recognizes income, the employer-corporation is entitled to a corresponding deduction.

The impact on U.S. Treasury receipts is, therefore, essentially offset at the exercise date, when the gain to the grantee is fixed. While this policy can work a hardship on employees who fail to segregate sufficient funds to meet their tax liability in that year, it's logic is irrefutable and has not been seriously questioned as a matter of tax policy.

Congress' creation of incentive stock options or ISOs, which qualify for different tax treatment is instructive as to the symmetry of income and deduction. When ISOs were created as non-taxable stock options it was made clear that the corporation was not entitled to a deduction because there was no income to the employee. Therefore, except in certain circumstances, this is the cases for all ISOs. However, if an ISO is not held by the employee for the statutory time period after exercise, the rule of symmetry works the other way, making the difference between exercise price and market price taxable to the employee and deductible to the corporation.

III. THE LEVIN-MCCAIN APPROACH TO STOCK OPTIONS IS BAD TAX POLICY.

S. 1940 would undermine this logic in an attempt to force a change in corporate behavior in financial reporting. This approach would undermine both the logic and symmetry of Section 83, the private sector accounting standards setting process and Congress' role in setting tax policy. By limiting the deduction to the corporation to an amount equal to the book entry expense at grant date – an amount that has nothing to do with the income recognized on the exercise date, S. 1940 would destroy the standard symmetrical relationship between the ordinary amount of income taxable to the grantee and the deduction to which the grantor is entitled. Although S. 1940 calls for a matching of the corporate tax deduction in the year the grantee exercises the option to the expense the company booked in the year in which the options were granted, such matching is impossible. The time separation between the book entry at grant and the tax event would be at least three years in most cases and as many as ten years in many cases because the right to exercise the option vests over a period of years. Thus, because of vesting, the book expense and the tax deduction will never match either in amount or in timing.

Furthermore, the tax deduction of the book expense will never materialize in many cases. Options will lapse because the exercise price never goes above the market price after the option is vested. Other options will also be forfeited before they vest when an employee leaves the company.

Under S. 1940 new mismatches will be created because of the tax treatment of ISOs. As noted above, the tax treatment depends upon whether the options are incentive stock options

("ISOs") or non-qualified options. However, the ISO/non-qualified option distinction that exists for tax purposes has no relevance in the financial accounting world. Instead, the financial accounting treatment of stock options depends upon whether the stock option plan is "fixed" or "variable." And if an expense is to be recognized, it must be recognized for all fixed and variable option plans. Thus, a book expense would have to be recognized for all options even if the company never could, under the tax rules, recognize a tax deduction (such as with ISOs).

S. 1940 is misguided for a number of additional reasons. For one, it would take the question of when and how much tax deduction is appropriate out of the hands of Congress and the Treasury and place it in the hands of the Financial Accounting Standards Board (FASB) and the SEC. S. 1940 attempts to address the disparity between book and tax accounting, not by changing the tax accounting rules *per se*, but instead, by requiring companies to recognize an expense for book if they want to recognize an expense for tax. Because the tax treatment of options would be driven solely by the financial accounting treatment, the deduction that the corporation would be entitled to would be based upon the rules of the FASB and the SEC, which recognizes the FASB's rules as appropriate for SEC-filed financial statements. At some point, this same determination could be in the hands of the International Accounting Standards Board, which works with accounting standards constituencies from around the world.

S. 1940 would also reduce the R&D tax credit for companies that do not recognize a fair value expense for stock options. In addition, for those companies that do expense stock options, their credit would likely be reduced and the already complex R&D tax credit computation will become even more complicated. The mismatches and administrative problems created by Levin-McCain will simply make matters worse by diminishing the tax credit's impact on the policy goal of encouraging R&D in the U.S.

Furthermore, Levin-McCain would promote arbitrary and potentially unsound financial reporting results that would then be reflected in tax deductions. Even assuming that there should be an expense, the option pricing models required to be used to value fixed options are not adequate to create a meaningful estimate. For example, the Black-Scholes option-pricing model, was designed to value freely tradable options such as those traded on the New York and American Exchanges– not employee stock options. Indeed, these are the types of options that Black-Scholes was designed to value. However, as Burton Malkiel and William Baumol, two well-recognized academics, recently stated in the *Wall Street Journal*, the Black-Scholes model was never intended to value employee stock options and cannot do so reliably. Too many assumptions must be made as to the marketability and transferability of options; vesting and exercise periods; projected dividends; and the volatility of the underlying stock over the entire life of the options. In addition, Black-Scholes was designed for options that are only exercisable at expiration. Most employee options vest and are then exercisable for a period of time. Option pricing models do not accurately account for these factors. Each of these assumptions leaves considerable room for honest mistakes – and for manipulation.

Many stocks pay dividends. Option pricing models generally make the opposite assumption. Thus, if a company does pay dividends, another assumption must be made to reduce the current share price used in the computation to reflect expected or projected dividends. As today's market shows, these projections can produce results far from reality. Another significant prediction that must be incorporated into such models is the volatility of the underlying stock expected over the life of the option. Could anyone have predicted that Enron's stock would triple in two years and then fall to be virtual worthlessness in a year? The wild fluctuations in

Enron's stock, although more extreme than most for obvious reasons, was not limited to that company. `Stock market volatility simply cannot be predicted with any degree of certainty.

Some suggest that the inadequacies of Black-Scholes make expensing at the exercise date rather than the grant date appropriate. However, requiring expensing at the exercise date would produce even more misleading and unreliable financial statements. Since the "cost" would equal the difference between the stock price and the option exercise price, the better the company was at increasing shareholder value, the more its earnings would be reduced. The best performing companies would have the worst looking income statements. Attachment D demonstrates this situation. Such results do investors no good.

As written, S. 1940 would make the tax decuction dependent on the Black-Scholes formula. It will also make a company's tax deduction differ vastly from the amount of income the employee is required to report. As a tax policy matter, there is no reason to make a company's tax deduction totally dependent upon such an inherently imprecise and arbitrary number. This is simply bad tax policy and adds unnecessary complexity to the Code.

Aside from tax policy, it is possible that S. 1940 would cause an increase in the number of financial statement restatements if a companies actual expense turned out to be materially different from the one reported under Black-Scholes.

The Levin-McCain approach will create an administrative nightmare by requiring an option-by-option, employee-by-employee tracing of the financial accounting expense in order to determine what tax expense the company could deduct. This administrative nightmare is a direct threat to the continued use of broad-based stock option plans.

IV. S. 1940 IS BAD ECONOMIC POLICY.

Stock options are a vital tool in the battle for economic growth and job creation. Stock options relate directly to the ability of companies, large and small, to attract, retain and motivate talent. Stock options are now utilized across the board by retail companies, manufacturers, bio-technology companies and, of course, high-tech companies. And they are increasingly granted to middle management and rank-and-file employees: The National Center for Employer Ownership estimates that up to 10 million employees in the United States will receive stock options in 2001, up from one million who received them in 1992. It also notes that, as of 2000, "90 percent of large publicly traded companies have stock options programs . . . and that 100 percent of venture backed companies offered stock options." This level of employee empowerment and commitment are at the heart of America's productivity gains over the past decade.

With entrepreneurial thinking, due in part to the current treatment of stock options, U.S.-based companies have a competitive advantage over their foreign counterparts. Levin-McCain-Fitzgerald would take this away. The current economy, especially the high tech economy, needs workers with the commitment and motivation that options provide.

V. STATEMENT OF FINANCIAL ACCOUNTING STANDARD (SFAS) 123, DEVELOPED THROUGH THE FASB PRIVATE SECTOR ACCOUNTING STANDARDS PROCESS IS THE RIGHT STANDARD FOR ACCOUNTING FOR STOCK OPTIONS.

Since 1995, THE FASB rule, SFAS 123 has permitted two methods of accounting for fixed stock options. Both methods call for accounting at the date of the options grant. However, companies can report an expense under one of two approved methods. The older of the two methods is based on "intrinsic value" which is the difference between the market price and the exercise, or "strike" price. In most cases, options are granted with a strike price at the market price, making the intrinsic value of the option at grant zero and creating an expense of zero. This method reflects what NVCA believes is the real cost to the corporation at grant – zero.

While permitting the use of intrinsic value, SFAS 123 encourages companies to report the expense under the "fair value" method of accounting. This requires the company to use a model-based approach to assigning a value, the most common of which is the Black-Scholes model. If companies do not record an expense at fair value, they are required to provide extensive footnotes that show what the impact of such an expense would have been on earnings per share. Therefore, regardless of whether a fair value expense is recorded, and regardless of whether the company or its investors see the grant of options as a cost to the company, anyone who wants to consider this information in analyzing the financial report of the company has it fully available on an annual basis.

Current accounting rules mandate that companies report their earnings per share as if all in-the-money options were exercised. This treatment reflects the reality of stock options: when, and if, they are exercised, a portion of the corporate ownership and claim on earnings shifts from current shareholders to the employees. There is no corporate level expense as there is when cash salaries are paid.

Significant additional information on stock options is reported elsewhere in financial statements and SEC disclosure. See, Appendix C.

Intrinsic value accounting, footnote disclosure of 'fair value" and diluted earnings per share combine to give investors the best available accounting for stock options. Options are not a cash expense, and they require no dissipation of the corporation's tangible assets.

Finally, as noted the "cost" of stock options is already reflected in corporate earnings per share. The dilution that shareholders absorb is part of the entrepreneurial bargain that boards and shareholders make when options are granted to employees.

VI. THE IMPACT OF A CHANGE IN EITHER ACCOUNTING OR TAX TREATMENT THAT WOULD MAKE STOCK OPTIONS MORE "EXPENSIVE" WILL HAVE AN ADVERSE IMPACT ON THE ENTREPRENEURIAL ECONOMY.

It is important to remember that the proposal to expense stock options is not a new idea resulting from the Enron crisis. Differing views on stock option accounting were argued extensively from 1986 to 1995. Several studies and surveys conducted at the time found that requirements to expense stock options would lower corporate earnings unless there were significant cutbacks in broad-based employee stock option programs. They also concluded that middle-class Americans would be hit the hardest, by depriving them of the options-based gains they use to buy homes, put their kids through college and provide for retirement. And it was clear that small-to-medium sized-companies, especially startups, would be hurt because of their reliance on options as a way to lure employees away from higher paying, more stable jobs. At the end of this useful debate, a compromise was reached that worked for everyone – it did not require companies to expense stock options, therefore saving broad-based stock options plans. It required, however, that companies choosing not to expense options disclose the effect of a "fair value" expense charge on net income and earnings per share in the financial statement footnotes, thus giving investors transparency. And the accounting rules have been tightened and other disclosure requirements have been added since then.

This was the right approach for the US Economy. During the last decade, stock options were a critical factor in fueling entrepreneurial innovation and economic growth. Central to the tremendous growth and global leadership of the American economy have been men and women motivated by the dream of financial independence through employee ownership. By offering employees the opportunity to share in the rewards as well as the risks of innovative new start-ups, entrepreneurs can attract the top talent and the venture capital necessary to turn a great idea into a thriving enterprise. Broad-based option plans allow every employee, from the CEO to the rank and file worker, to have a stake in the company's success.

Venture capital investors are among the firmest believers in the use of stock options for two purposes. First, it takes stock options to lure the kind of managerial talent that is highly prized in any business to the risky, intense and volatile experience of the start-up. Second in takes stock options to bring the focused, highly-motivated sense of shared purpose that is critical to the success of an innovative new venture. Venture capitalists are investors who affirmatively give up part of their stake in the company because they believe that there is no better way to recruit talent, motivate employees and grow a company.

Without a doubt, stock options are an important part of successful formula. Venture-backed companies, steeped in the culture of shared ownership, have had an enormous impact on the American economy. As noted earlier an NVCA-commissioned independent study by DRI-WEFA, which measured this impact, is attached. DRI-WEFA major findings bear repeating: from 1970 to 2000, venture-backed companies have created more than 7 million new jobs, 5.9% of the U.S. total. These same companies generated $1.3 trillion in revenue, 13.1% of GDP, in 2000 alone. In the current shower of negative press over the excesses of a few, it is important to keep our eye on the real economic prize and the role that stock options have played in maintaining economic growth.

As we can see from the troubles in many economies, here and abroad, growth in jobs and GDP cannot be taken for granted. The U.S. faces significant challenges in continuing to develop the means to give every person the tangible rewards and the sense of purpose that comes from participating fully in economic life. Stock options are a proven tool at our disposal for meeting these challenges. Just as stock options have been an essential part of the engine that has driven America's entrepreneurial leadership and economic growth over the last decade, they can be a key to a brighter future for many more. They are in part what distinguishes our powerful economy, and are even more vital growth tools when we need to pull ourselves out of economic downturn.

But the U.S. does not have a monopoly on stock options. We see an example of the need to be prudent in the technology area, which has serious competitors outside the U.S. Taiwan, for example, has built great technology companies on the foundation of stock options. Taiwan companies do not have to expense stock options in their P&L statements. These strong Taiwanese companies have been built with American engineers and managers who joined them in part because of more favorable stock option treatment in Taiwan. The Peoples Republic of China is also beginning to build a technology industry with the help of stock options. Several European nations are revising their accounting rules to encourage the use of stock options. The world has taken notice of our economic success and has discovered the importance of stock options as a competitive tool.

Other jurisdictions are moving to change their accounting and tax rules to accommodate broader use of stock options. We stand to lose our technological edge if we do not continue to offer this incentive to our most ambitious and energetic employees.

I reiterate that what is good about stock options can be preserved and made better through better disclosure, better corporate governance and greater accountability to shareholders. NVCA, and the many business organizations that share our views, look forward to working with the Committee, the SEC and the other agencies that have assumed their proper responsibility in addressing these issues.

Thank you for the opportunity to express NVCA's views on these vital issues.

Attachment A – DRI-WEFA Study

Attachment B – NVCA April 15, 2002 letter to SEC Chairman Harvey Pitt

Attachment C – Summary of Current Disclosure on Stock Options, Restrictions on Insider Transactions and

Attachment D – Examples of Expensing at Date of Exercise

Research Finds That $36K of VC Investment Creates a US Job

First Time State-by-State Rankings Available

October 22, 2001—Washington, DC - Final results of an economic impact study released today by the National Venture Capital Association (NVCA) reveals that venture capital invested during the period 1970 - 2000 created 7.6 million U.S. jobs and more than $1.3 trillion in revenue as of the end of 2000. The research, conducted by DRI-WEFA, formerly Wharton Econometrics, and commissioned by the NVCA, shows that $273.3 billion of venture capital created companies that were responsible for 5.9% of the nation's jobs and 13.1% of the U.S. Gross Domestic Product in 2000. Venture investment led to job and revenue creation most frequently in the computer, consumer, and medical health sectors industry sectors followed by the communications, industrial energy, electronics and biotech. The figures released today are substantially higher than preliminary numbers released in May as they include not only independent venture-backed enterprises but also those venture-backed companies that have been acquired.

"Venture capital creates jobs and is vital to the growth of our nation's economy as evidenced by what it created from 1970 to 2000. This research shows that one American job existed in 2000 for every $36,000 dollars of venture capital invested over the last three decades. As we look forward to the next thirty years, we expect venture capital to play a critical role in nourishing entrepreneurial companies and sparking innovation," commented Mark G. Heesen, President of the National Venture Capital Association. "Venture capital plays an increasingly vital role during difficult economic times such as these, as it is one of the few sources of risk capital available to innovative businesses. Some of today's most successful companies were founded in difficult economic environments."

"Our analysis demonstrates the tremendous impact venture capital has had on job and revenue creation in the United States during the past thirty years. Given that venture capital was less than one percent of U.S. investment activity during most of the period studied, its impact is remarkable," remarked Joseph Kasputys, Chairman of Global Insight, which is the parent company of DRI-WEFA.

Key States Lead the Country in Venture Capital Investment and Impact

The NVCA also released today data that details venture-backed job and revenue creation by state. Topping both lists are California, Texas, Pennsylvania, Massachusetts, New York, and Washington.

ATTACHMENT A

YEAR 2000 JOBS REPRESENTED BY VENTURE-BACKED US COMPANIES By State*					
Rank	State	Jobs	Rank	State	Jobs
1	California	1,415,748	26	Kansas	58,004
2	Texas	676,158	27	Idaho	48,822
3	Pennsylvania	424,652	28	Louisiana	46,009
4	Tennessee	382,049	29	Iowa	39,066
5	Massachusetts	381,433	30	Arizona	38,575
6	New York	369,314	31	Kentucky	32,092
7	Georgia	338,188	32	Utah	26,593
8	Washington	263,585	33	Oregon	23,227
9	New Jersey	260,114	34	Rhode Island	19,174
10	Florida	243,578	35	South Carolina	16,951
11	Virginia	207,777	36	Nebraska	15,171
12	Illinois	180,837	37	Maine	10,191
13	Ohio	178,838	38	Delaware	9,038
14	Minnesota	165,707	39	Arkansas	8,894
15	North Carolina	122,577	40	Oklahoma	8,690
16	Connecticut	115,026	41	New Mexico	5,536
17	New Hampshire	114,393	42	Alaska	5,398
18	Michigan	103,578	43	Nevada	3,739
19	Mississippi	81,090	44	North Dakota	2,945
20	Wisconsin	81,002	45	Hawaii	2,337
21	Missouri	75,390	46	Vermont	1,748
22	Alabama	71,669	47	Montana	1,525
23	Maryland	63,482	48	Washington DC	955
24	Colorado	62,971	49	West Virginia	252
25	Indiana	61,765	50	South Dakota	236

Source: DRI-WEFA & National Venture Capital Association

YEAR 2000 REVENUES FROM VENTURE BACKED US COMPANIES
By State**

Rank	State	Revenues	Rank	State	Revenues
1	California	270,615,616,030	26	Kentucky	11,594,169,444
2	Texas	158,182,683,770	27	Michigan	10,785,665,480
3	Washington	75,392,483,788	28	Kansas	7,332,574,615
4	New York	65,847,643,419	29	Arizona	6,121,028,749
5	Georgia	62,797,329,123	30	Iowa	5,464,597,383
6	Pennsylvania	58,037,077,758	31	Utah	4,813,825,717
7	Massachusetts	48,848,353,174	32	Louisiana	4,770,270,407
8	Illinois	41,294,755,150	33	Oregon	3,368,712,540
9	Mississippi	39,362,280,000	34	South Carolina	2,503,679,883
10	New Jersey	38,151,135,954	35	Oklahoma	1,721,211,154
11	Florida	36,446,672,197	36	Nebraska	1,417,103,902
12	Virginia	35,689,133,157	37	Arkansas	1,345,637,794
13	Tennessee	33,397,219,240	38	Alaska	1,208,217,000
14	Minnesota	27,031,944,328	39	Maine	1,184,955,819
15	Connecticut	22,927,139,421	40	Rhode Island	1,095,502,980
16	Wisconsin	18,401,589,243	41	Delaware	804,448,857
17	North Carolina	18,146,256,986	42	Hawaii	623,003,264
18	Ohio	18,087,699,760	43	New Mexico	595,775,648
19	Missouri	17,491,532,002	44	Nevada	571,950,139
20	Idaho	16,867,055,200	45	Vermont	237,300,000
21	New Hampshire	14,678,537,740	46	Montana	180,903,173
22	Colorado	14,564,791,625	47	South Dakota	35,198,370
23	Indiana	13,274,383,722	48	Washington, DC	33,183,000
24	Alabama	12,379,345,587	49	West Virginia	26,700,000
25	Maryland	12,172,860,978	50	North Dakota	8,294,255

Source: DRI-WEFA & National Venture Capital Association

"Venture capital investment is a national phenomenon that helps set the US economy apart from others in the world," said Thomas McConnell of New Enterprise Associates and Chairman of the National Venture Capital Association. "The DRI-WEFA/NVCA study clearly demonstrates that innovation is being cultivated in every region of the United States. As long as there are strong research institutions, an entrepreneurial-friendly legislative and regulatory environment, and a technologically savvy workforce, entrepreneurship and economic growth will prevail in this country."

TOP TEN STATES FOR TOTAL VENTURE DOLLARS INVESTED 1970 - 2000					
Rank	**State**	**VC Invested ($mil)**	**Rank**	**State**	**VC Invested ($mil)**
1	California	$108.809.90	6	New Jersey	$9.137.84
2	Massachusetts	$25.986.00	7	Washington	$7.383.45
3	Texas	$17.189.20	8	Virginia	$7.215.19
4	New York	$16.070.02	9	Pennsylvania	$7.186.96
5	Colorado	$9.881.09	10	Georgia	$6.435.34

Source: Venture Economics/National Venture Capital Association

There was an unprecedented geographical diversification of venture capital during the past five years. While states such as California, Massachusetts and New York have consistently been national hotbeds for venture investing, other states showed considerable growth and promise including Maryland, Minnesota, Georgia, Oregon and Colorado.

TOP 15 FASTEST GROWING STATES FOR VC INVESTMENT
1996 - 2001 (5 Year Annual Compound Growth Rate)

Rank	State	VC Invested 1996	VC Invested 2001 (Est)	5 Year CAGRiii
1	Maryland	99.73	1,011.50	58.94%
2	Minnesota	114.28	526.33	35.72%
3	Massachusetts	984.07	4,455.93	35.26%
4	Georgia	226.75	996.39	34.45%
5	Oregon	71.60	312.91	34.31%
6	New York	498.97	2,080.27	33.05%
7	Colorado	305.44	1,226.83	32.06%
8	Texas	726.74	2,678.78	29.81%
9	Connecticut	173.07	564.71	26.68%
10	California	4,858.03	14,431.29	24.33%
11	New Jersey	423.04	1,206.77	23.32%
12	Washington	351.94	907.76	20.86%
13	Florida	332.74	844.03	20.46%
14	Virginia	493.27	971.05	14.51%
15	Illinois	298.29	573.49	13.97%

Source: Venture Economics National Venture Capital Association

In addition to the jobs and revenue created by venture capitalists, intellectual capital and innovation also are borne of this type of investment. The NVCA and DRI-WEFA will be looking at such measures in the weeks to come as part of their larger joint project to quantify the economic impact of venture capital on the U.S. and global economies.

The DRI-WEFA study on the Economic Impact of Venture Capital was commissioned by the NVCA and was conducted in the first half of 2001. A database of originally ventured companies in the United States going back to 1970 was mapped to the current companies in the Dun and Bradstreet Database to determine jobs and revenues represented in 2000. The data was then cut by geography and industry. Additional phases of research, which will measure venture capital contribution to technological progress and quality of life, will be conducted later this year. These economic figures were revised upward significantly from the first phase of research as the numbers now take into account originally venture-backed companies that were acquired by larger, publicly traded organizations.

The National Venture Capital Association (NVCA) represents more than 430 venture capital and private equity firms. NVCA's mission is to foster the understanding of the importance of venture capital to the vitality of the U.S. and global economies, to stimulate the flow of equity capital to emerging growth companies by representing the public policy interests of the venture capital and private equity communities at all levels of government, to maintain high professional standards, facilitate networking opportunities and to provide research data and professional development for its members. For more information about NVCA, please visit www.nvca.org.

DRI-WEFA is one of the world's leading economic information and consulting firms. Staffed with more than 200 economists, DRI-WEFA collects and analyzes data from around the globe, monitors developments in over 152 countries, provides objective, highly regarded, detailed analyses of economic, financial and industry activity and provides clients with custom solutions for their information needs. Founded as Wharton Econometric Forecasting Associates in 1963 by Lawrence R. Klein, the 1980 Nobel Laureate, DRI-WEFA merged with Chase Econometrics in 1987. Among their more than 3000 clients DRI-WEFA enjoys a worldwide reputation for the highest standards, analytical power and industry insights.

Venture Economics, a Thomson Financial company, is the foremost information provider for private equity professionals worldwide. Venture Economics offers an unparalleled range of products from directories to conferences, journals, newsletters, research reports, and the VentureXpert (tm) database. For over 35 years, Venture Economics has been tracking the venture capital and buyouts industry. Since 1961, it has been a recognized source for comprehensive analysis of investment activity and performance of the private equity industry. Venture Economics maintains long-standing relationships within the private equity investment community, in-depth industry knowledge and proprietary research techniques. Private equity managers and institutional investors alike consider Venture Economics information to be the industry standard.

*Shown in Chart are venture-backed jobs that were attributed to specific states. The study also found 733,912 jobs that were not able to be identified with a specific state due to acquisitions. This number is reflected in the 7.6 million job total.

** Shown in Chart are venture-backed revenues that were attributed to specific states. The study also found $62.1 billion in revenues that were not able to be identified with a specific state due to acquisitions. This number is reflected in the $1.3 trillion revenue total.
iii Methodology compared the 1996 venture investment with estimated 2001 totals which were based on first half results multiplied by a factor of 1.55. Only those states which had projected venture capital investment greater than $300M in 2001 were considered.

NVCA
National Venture Capital Association

April 15, 2002

The Honorable Harvey Pitt
Chairman
Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549

Re: Corporate governance reforms affecting stock options

Dear Chairman Pitt:

In light of recent reports alleging inappropriate corporate activity in the use of stock options and in view of legislative proposals designed to correct these real or perceived abuses, we were pleased to learn from your recent public comments that you are advocating a more direct and appropriate approach to reform in order to restore investor confidence.

The growth in the use of stock options and their ubiquity across industries have rightfully raised questions regarding their effect on corporate behavior and shareholder rights. Few will deny that stock options have had great utility in aligning the interests of workers with shareholders, thereby contributing to worker productivity, stronger performance by the company and growth in our overall economy. However, at the same time, we acknowledge that current corporate governance lapses have led to abuse.

As the true "cost" of stock options is their dilution effect on earnings per share, it is fitting that policies going forward focus on providing shareholders greater input regarding their issuance. Furthermore, securing enhanced independence for board compensation committees and taking additional steps to assure that stock options awards are tied more closely to the long-term performance of companies will further ensure that stock options are truly in the interests of the company and its shareholders.

As always, we support aggressive investigations by the Commission into illegal accounting and other questionable activity of certain companies. The successful conclusion of these investigations under current law will benefit industry and the capital markets as well as shareholders. We recognize the resource constraints that the Commission is facing and we will be working with Congress to assure adequate funding for these and other important activities.

As we move forward, we are eager to work with you to strengthen public confidence in the governance of America's public companies and in their use of stock options. Given that stock options are so critically important to our economy, we are encouraged by your leadership in identifying and articulating the appropriate path to reform.

Sincerely,

Mark G. Heesen
President

ATTACHMENT B

CURRENT DISCLOSURES ON STOCK OPTIONS, RESTRICTIONS ON INSIDER TRANSACTIONS & DEDUCTIBILITY OF EXECUTIVE COMPENSATION

I. DISCLOSURES ABOUT STOCK OPTIONS SPECIFICALLY

A. In the Annual Audited GAAP Financial Statements

1. **Statement of Financial Accounting 123 on Stock Options requires, at a minimum, *pro forma* footnote disclosure of:**

   (a) Net income and earnings per share based on the inclusion of an expense for stock options granted annually for the current year and the previous three years.

   (b) A summary table of stock options plans with weighted average exercise prices for options granted and the number of options granted and available for grant under the plan.

   (c) A description of assumptions used in developing the fair value of options granted.

   Note: The full requirement is extensive and detailed. A full description of all the requirements takes up the entire 42 pages of Appendix B to SFAS 123. A typical company provides a full page or more of disclosure on stock options in a footnote to a company's annual financial statements.

2. **Annual and Quarterly GAAP Financial Reports Include Diluted Earnings per Share.**

   Mandatory annual and quarterly SEC filing show the impact of stock options grants on the earnings per share calculation in the form of "diluted earnings per share" in the financial statements.

B. Annual Disclosure of Potential Dilution of Current Shareholders Through Stock Option Plans is Required by the SEC.

A December, 2001 SEC Rule, which will go into practice in the late Spring, mandates tabular disclosure of an options plans "dilution table" in annual shareholder communications (10k or proxy materials). The table shows:

1. Aggregated disclosure of all stock options plans that are approved by shareholders.
2. Aggregated disclosure of all stock options plans that are not approved by shareholders.
3. Total number of shares issued and total number available for issuance in all plans.
4. Weighted average exercise price of options, warrants and rights outstanding under the plans.

ATTACHMENT C

II. DISCLOSURE ON EMPLOYEE STOCK OPTIONS AS PART OF MORE COMPREHENSIVE DISCLOSURES

A. Disclosure Regarding and Regulation of Officers, Directors and other "Insiders" who Receive Stock Options

1. **Annual Report/Proxy Disclosure on Executive Compensation.** Public issuers are required to disclose in their Annual Reports or Proxy Statements information on executive compensation as detailed below.

   (a) Executive Compensation. Compensation paid to the issuer's CEO and each of the next four (4) most highly compensated executive officers other than the CEO (the "Top 5") are reported in their annual reports or proxy statements. The required disclosure includes:

      (i) Aggregate Compensation. Aggregate annual compensation paid in each of the last three (3) years, including:

         (1) Salary, bonus and all other compensation paid, and

         (2) All long-term compensation, including options and restricted stock awards.

      (ii) Option/Stock Appreciation Rights (SAR) Grants. Individual grants of stock options made during the last year, including:

         (1) The number of securities underlying options and SARs granted;

         (2) The percent the grant represents of total options and SARs granted to employees during the fiscal year;

         (3) The per-share exercise or base price of the options or SARs granted. (If such exercise or base price is less than the market price of the underlying security on the date of grant, the market price on the date of the grant must be disclosed);

         (4) The expiration date of the options or SARs; and

         (5) Either (1) the potential realizable value of each grant of options or freestanding SARs, or (2) the present value of each grant.

      (iii) Aggregated Option/SAR Exercises and Fiscal Year-End Option/SAR Value. Exercises of stock options and SARs during the last year and the fiscal year-end value of unexercised options and SARs on an aggregated basis, including:

(1) The number of shares received upon exercise, or, if no shares were received, the number of securities with respect to which the options or SARs were exercised;

(2) The aggregate dollar value realized upon exercise:

(3) The total number of securities underlying unexercised options and SARs held at the end of the last completed fiscal year, separately identifying the exercisable and un-exercisable options and SARs; and

(4) The aggregate dollar value of in-the-money, unexercised options and SARs held at the end of the fiscal year, separately identifying the exercisable and un-exercisable options and SARs.

(iv) Long-Term Incentive Plan ("LTIP") Awards. Each award made during the last year under any LTIP, including:

(1) The number of shares, units or other rights awarded under any LTIP, and, if applicable, the number of shares underlying any such unit or right.

(2) The performance or other time period until payout or maturation of the award.

(3) For plans not based on stock price, the dollar value of the estimated payout, the number of shares to be awarded as the payout or a range of estimated payouts denominated in dollars or number of shares under the award.

(b) Repricing of Stock Options: The Proxy Statement is required report on Re-pricing of Options and Stock Appreciation Rights (SARs) during the last ten (10) years, including:

(1) The date of each re-pricing;

(2) The number of securities underlying replacement or amended options or SARs;

(3) The per-share market price of the underlying security at the time of re-pricing;

(4) The original exercise price or base price of the cancelled or amended option or SAR;

(5) The per-share exercise price or base price of the replacement option or SAR; and

(6) The amount of time remaining before the replaced or amended option or SAR would have expired.

2. Director Compensation and Securities Ownership.

(a) Options Grants and Compensation of Directors. A description of any arrangements, stating amounts, pursuant to which directors of the issuer are compensated, including in the form of option grants, for any services provided as a director, including any additional amounts payable for committee participation or special assignments.

(b) Security Ownership of Certain Beneficial Owners and Management. The total number of shares (including vested options) beneficially owned and the percentage owned for all directors and executive officers, and for each owner of more than five percent (5%) of any class of the issuer's voting securities.

B. Insider Transactions are Reported to the SEC, and are Public Documents, under Section 16 of The Exchange Act.

In general, Section 16 applies to "Insiders", company policy-making officers, directors and 10% shareholders. It is intended to deter Insiders from misusing confidential information about their companies for personal trading gain. Section 16(a) requires insiders to publicly disclose any changes in their beneficial ownership of an issuer's equity securities, including options and other convertible securities. Section 16(b) requires insiders to disgorge to the Company any "profit" resulting from "short-swing" trades, as discussed more fully below. Section 16 covers all securities, including options and other convertible securities, beneficially owned either directly by the insider or indirectly through others. An insider is considered the indirect owner of any securities from which he obtains benefits, e.g., owned through or by corporations, trusts, estates, or family members.

1. Disclosure and Filing Requirements for Insider Transactions – 16(a) Reporting. Insiders must file with the SEC and any stock exchange on which an issuer's equity securities are quoted public reports disclosing their holdings of, and transactions involving, an issuer's equity securities. Copies of these reports must also be submitted to the issuer. An initial report on Form 3 must be filed by every Insider upon his or her election or appointment disclosing all equity securities of the issuer beneficially owned by the reporting person on the date he or she became an Insider. Any subsequent change in the nature or amount of beneficial ownership by the Insider must be reported on Form 4 each month. Certain exempt transactions may be reported on Form 5 after the end of the fiscal year. All changes in the amount or the form (i.e., direct or indirect) of beneficial ownership (not just purchases and sales) must be reported.

2. Profit Disgorgement. Any profit realized by an insider on a "short-swing" transaction (i.e., a purchase and sale, or sale and purchase, of an issuer's equity securities, within a period of less than six months) must be disgorged to the issuer upon demand by the issuer or a stockholder acting on its behalf. Liability under Section 16(b) is strict, without regard to the insider's intent. A "purchase and sale" under Section 16(b) covers a broad

range of transactions, including acquisitions and dispositions of options and other convertible securities.

III. CIVIL AND CRIMINAL LIABILITY FOR INSIDER TRADING

The federal securities laws prohibit any person buying or selling securities, including securities acquired upon exercise of options, if he or she is in possession of material inside information that he or she has a duty to keep confidential. Information is material if it could affect a person's decision whether to buy, sell or hold the securities. It is inside information if it has not been publicly disclosed. Furthermore, it is illegal for any person in possession of material inside information to provide other people with such information or to recommend that they buy or sell the securities. (This is called "tipping"). Criminal and civil penalties apply up to ten years. Issuers and officers or directors who are implicated in another person's insider trading face civil and criminal penalties.

IV. RESTRICTIONS ON SALES OF ISSUER'S SECURITIES

The Securities Act requires every person who offers or sells a security, including Insiders who resell securities of an issuer to register such transaction with the SEC unless an exemption from registration is available. Rule 144 under the Securities Act is the exemption typically relied upon for public resales by officers, directors and other control persons of a company (known as "affiliates") of an issuer's securities, regardless of how or when required. Rule 144 contains a number of conditions on such sales, including filing a notice of the proposed sale with the SEC at the time the order to sell is placed with the broker, unless the amount to be sold meets certain de minimus thresholds. A seller relying on Rule 144 must file a notice of proposed sale with the SEC at the time the order to sell is placed with the broker.

V. SHAREHOLDER APPROVAL OF STOCK OPTIONS PLANS

The listing requirements of the NYSE, the Nasdaq Stock Market and the American Exchange require shareholder approval of all officer and director stock option plans. There is an exception from shareholder voting for broadly-based plans under which 50% of employees are eligible to receive stock options and at least 50% of the plan's options are granted to employees who are not officers or directors.

VI. LIMITATIONS ON DEDUCTIBILITY OF EXECUTIVE COMPENSATION

Section 162(m) of the Tax Code restricts the deductibility of the compensation of the five most highly compensated executive of a publicly traded company to $1 million per year unless the compensation is performance-based. Requirements for qualification of compensation as performance-based includes board and shareholder approval of performance goals and certification of achievement of goals by a compensation committee made up of outside directors.

Example of Expensing At Date of Exercise

__Situation 1 - Poorly Performing Stock__

Exercise Price $10

Stock Price at date of Exercise $15

Current Law Result:

Employee recognizes $5 income (difference between $15 and $10)

Employer has a tax deduction of $5

Under Levin-McCain (as described): Net income also reduced by $5

Assume: Net income before option expense	$100
Option Expense	$5
Net income after option expense	$95

__Situation 2 Exceptionally Performing Stock__

Exercise Price $10

Stock Price at date of Exercise $110

Current Law Result:

Employee recognizes $100 income (difference between $110 and $10)

Employer has a tax deduction of $100

Under Levin-McCain (as described): Net income also reduced by $100

Assume: Net income before option expense	$100
Option Expense	$100
Net income after option expense	$0

- **Assuming 2 identical companies, the better the stock performs, the worse the financial statement appears. This will ALWAYS be the result.**
- **Financial accounting policy seeks transparency and comparability. Introducing the stock price into the income statement totally obscures both.**
- **Tax policy is has totally different motivations. Public policy, revenue raisers, etc.**

ATTACHMENT D

Myths and Realities of Executive Pay

Ira T. Kay, Ph.D.
Practice Director, Compensation Consulting
Watson Wyatt Worldwide

Testimony before the
Senate Finance Committee

April 18, 2002

The views in this statement are those of the author and do not necessarily reflect the views of Watson Wyatt Worldwide or any of its other associates.

Introduction

Executive pay practices have been controversial in the United States for the past 15 years. In the late 1980s and early 1990s, critics argued that there was not enough pay-for-performance -- that executives did not have their pay linked to the performance of their companies' stock. Over the years there has been a tremendous increase in the size of executive pay increases -- 15% to 20% annual compound growth rates at the typical billion dollar company. Most of that increase has been in the form of stock-based compensation, primarily stock options.

During that time the performance of many American companies and the U.S. economy has been spectacular. Whether that performance is a *coincidence* with the rise of stock-based incentives or whether this type of executive pay played a significant role in *causing* that superior performance has been hotly debated. Despite the high-profile examples of extremely high pay for low performance, *I believe that these pay practices,* in combination with many other factors ranging from low interest rates and favorable demographics to globalization, *were an important component in creating the successful U.S. economic model.*

Executive pay, especially CEO pay, is *currently* controversial for a number of specific reasons. CEO pay levels in a few instances have reached into the hundreds of millions of dollars for a single year. Is any employee worth that type of money? Also, in some instances, there have been examples of CEOs being highly rewarded for mediocre or even poor performance. Is that fair? The examples of overstated profits or even outright fraud make this situation even worse. And the situation is compounded by the ability of executives to time the exercise of their options and the sale of their stock. Added into this stew is the peculiar fact that stock options are accounted for differently from other forms of compensation.

It is no wonder that this area is so criticized. However, I believe that it is essential to take a hard objective look at the data. It is a well-researched area by academics. Watson Wyatt also has done numerous studies looking at these questions and others. *And most importantly, I believe that shareholders -- the final arbiters of this controversy -- need to look at the typical individual company and not the outliers.*

In this spirit, I present the following list of Myths and Realities of Executive Pay:

Myths and Realities of Executive Pay

1. **Highly Paid CEOs:** CEOs of billion dollar companies are well paid by the standard of regular employees.

TRUE: The typical CEO of the largest 1200 companies had salary, bonus, plus stock options exercised equal to $1.3 million.*

And yes there are those $100 million paychecks (seven of them in 2001).

However, relative to the enormous economic value created by these executives, they appear to be worth the expense and they look even better in comparison to lower-paid Japanese CEOs who run troubled companies.

Further, looking at other labor markets (athletes and movie stars, for example) these pay levels seem far less extreme, given the accountability, job creation and value-creating opportunities of the typical corporate CEO.

2. **No Pay-for-Performance:** There is no pay-for-performance for executives. All CEOs became rich on their stock options, which went up in value because the stock market went up, under the "rising tide lifts all boats" theory. CEO pay only goes up, and never goes down, even if the performance of the company is poor.

FALSE: Watson Wyatt and much academic research show two important findings:

*a. The highest paid CEOs work for the highest performing companies. This is true both in terms of pay opportunity "before-the-fact" and actual pay "after-the-fact." I believe that the pay opportunities in the form of stock incentives, in fact, help to **cause** the superior performance at many companies and at the macroeconomic level.*

*b. Executive pay levels at most companies go up **and down** with the performance of their company in a given year. Over the past 10 years, it is true that total pay (cash plus exercised stock options) has gone up at the typical company at the same time that performance has been excellent. The big test has come over the past two years when profits and the stock prices have been flat or declined for many companies.*

We found for both 1999-2000 and 2000-2001 that total pay went down significantly, commensurate with the decline in performance (profits and stock price). For example, looking at those largest 1200 companies, we found that total pay went down by nearly 30%, with nearly 72% of the CEOs experiencing a decline. For a smaller sample of larger companies in 2001, we found an additional 50% of CEOs experiencing a decrease in total pay, netting to a 1% decline. These are clear examples of pay-for-performance.

Are there examples, where pay goes up while profit and stock prices go down? Yes -- but these are much more the exception than the rule. And these inconsistencies are quickly called out by institutional investors, the media and the like.

* 2000 Data

3. **Stock Options are Ineffective:** Stock options have had no positive impact on the financial and stock market performance of the typical U.S. company and have been a waste of shareholder resources.

*FALSE: Our studies and numerous academic studies, including one by the Fed,** have shown that there is a positive correlation between grants of stock options and the financial and stock market performance of most companies. This is true in both compensation opportunity as well as the resulting actual compensation (see Watson Wyatt's studies, Executive Pay in 2002, and Managing Stock Option Overhang in Today's Economy, 2002).*

4. **Too Many Stock Options:** However, there are a number of companies who have stock option levels beyond a comfort zone for shareholders and are not receiving an adequate return on that investment.

TRUE: Our research and academic studies have shown that companies with excessively large amounts of stock option "overhang" have lower returns to shareholders than companies with more moderate usage. (Stock option overhang is defined as the number of stock options granted plus those remaining to be granted as a percent of a company's total shares outstanding.)

5. **Stealth Compensation:** There are massive amounts of "stealth" compensation out there, where executives are getting paid under the table when they do not earn money on their bonuses and stock options.

FALSE: There are examples of CEOs getting special perquisites from their companies, ranging from use of the corporate jet to consulting contracts. These perks, however, represent a tiny part of the total executive pay program. We estimate these at substantially less than 1% of total pay.

Watson Wyatt's Human Capital Index® research shows that companies that are hierarchical and have lots of status distinctions perform more poorly than those with fewer perks. Therefore, I typically advise companies to minimize these programs.

6. **Stock Options are Perfect:** Stock options perfectly align the interests of executives with those of outside shareholders.

FALSE (or, rather, not entirely true): Stock options have no downside risk and therefore are an imperfect substitute for real share ownership by employees. Stock options also do not generally end up as shares owned, but are more likely to be exercised and sold than held as shares. Furthermore, our research and others have shown that options may motivate executives to undertake riskier business strategies.

7. **Executive Stock Ownership:** Executive stock ownership is very helpful to companies.

TRUE: Research has shown that companies with significant amounts of executive stock ownership perform better than companies with low stock ownership.

** "Recent Trends in Compensation Practices," David Lebow et al., 1999

8. **CEO Labor Market:** The labor market for executives is a "rigged" labor market where the CEO stacks the Board with his or her friends and they in turn set pay at as high a level as possible. The compensation committee is comprised mostly of insiders who do whatever the CEO wants them to do. These Board members spend their time approving egregious compensation programs that are not approved by the shareholders.

FALSE: The CEO labor market meets all of the criteria of any market, including independent supply and demand, transparency and liquidity.

My experience in attending compensation committee meetings is that these Board members are thoughtful and independent and take their responsibilities very seriously. They frequently vote down or modify management's proposals on pay matters. And as a general course of business they send most (90%+) stock-related proposals to the shareholders for their approval.

9. **Stock Option Re-pricing:** Options are frequently "re-priced" when the stock price declines. (By re-priced, I mean that the strike price is lowered some time after the original stock option grant is made thereby creating a huge advantage for the employees relative to the shareholders.)

FALSE: While some companies have re-priced their stock options over the past few years, this is far more the exception than the rule. Our research shows that no more than a few hundred companies of the more than 10,000 publicly traded companies, have re-priced. This represents a few percentage points at most.

10. **Inside Information:** Executives have inside information that allows them to time their sale of stock as well as the timing of their stock option grants and exercises.

TRUE AND FALSE: Executives have more information than outside investors, which is why many companies have "blackout" periods on sale of stock. However, I think this is an area that companies could police better, for example requiring executives to announce ahead of time that they are going to sell (something already covered under securities laws).

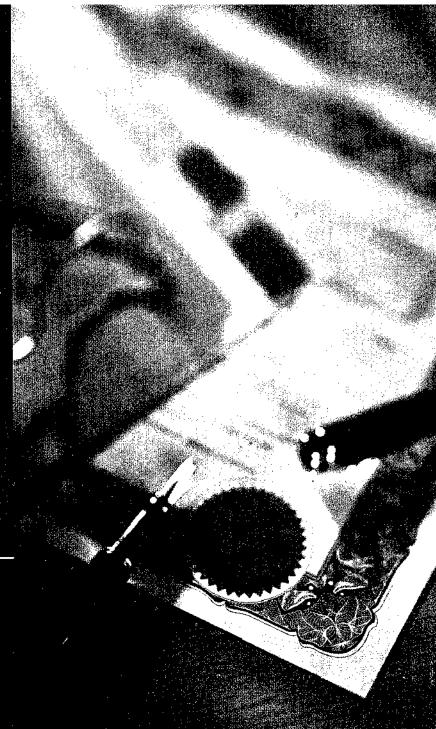
11. **Accounting for Stock Options:** Current accounting rules for stock options are unfair to shareholders and there is no logical reason why these rules differ so much from the corporate tax rules for options.

FALSE: Watson Wyatt and academic research show that shareholders are incorporating the amount of stock options into today's stock price despite the fact that stock options are only ***disclosed*** *and are not, in fact,* ***expensed****. This is consistent with the current footnote disclosure combined with the efficient market hypothesis.*

While the accountants may feel a need to change the accounting rules for options, there is a basic logic to how the current rules were developed in 1973. The FASB did not look to the IRS for guidance, but to other accounting rules relating to corporate derivative securities, (e.g., puts and calls). They basically made the accounting for employee options consistent with those rules for derivative securities, namely no impact on the income statement.

Conclusion

In conclusion, while executive pay remains controversial, I believe that the U.S. pay model has been much more helpful to our companies than harmful. Investors need to look at the typical company's behavior and not the most extreme examples. Many of the perceptions about executive pay out there are false, and not at all reflective of reality. I do believe, however, that there are some areas—notably increasing stock ownership and managing stock sales—that could be improved.



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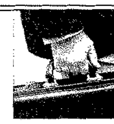
Executive Pay in 2002

Compensation in Turbulent Times

Watson Wyatt
Worldwide



EXECUTIVE PAY IN 2002: COMPENSATION IN TURBULENT TIMES

Introduction

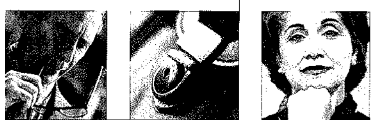
The third millennium has started with great economic uncertainty. Throughout the 1990s, the stock market continued its climb virtually unabated. However, strong concerns emerged over the high valuations of many companies, especially those in the technology sector. Early in 2000, sectors within corporate America began to experience declining sales and signs of overcapacity. Soon company revenue growth and profitability targets came into question.

Equity markets responded sharply. By the end of 2000, the S&P 500 had declined by 10.1 percent for the year, and 13.6 percent from the peak of the market in March. Most other indexes also fell in 2000 — the Russell 3000 dropped by 8.5 percent while the Nasdaq Composite plunged 39.3 percent. The stock market bubble that had emerged began to deflate as investors grew cautious of the disconnect between company valuations and their underlying economics. As the downturn broadened to other sectors, the unknown state of the overall economy and a recession exacerbated stock market volatility, already at historically high levels, and continued to plague the markets for all of 2001.

Watson Wyatt believes that there is a strong relationship between executive pay programs and company financial performance. Since the majority of executives' compensation packages are typically in the form of stock-based awards, their future wealth is closely tied to the overall performance of the company. Our basic theory: executives with more stock ownership and greater opportunity to participate in the appreciation of the stock, through stock options, have their interests aligned with those of the shareholders. Therefore, as the wealth of the shareholders increases or decreases, so will the wealth of the CEO and other top executives who manage the firm.

During the past seven years that Watson Wyatt conducted this study of U.S. executive pay, the stock market has been on a winning streak. Over this period of time, our analysis consistently showed that there is a relationship between pay and performance. We have found that:

- Companies with CEOs with high stock ownership levels (excluding stock options) financially outperform those with lower CEO ownership. We have measured this performance in terms of Total Returns to Shareholders (TRS), Return on Equity, Earnings Per Share (EPS) growth, and Tobin's Q, among others.



- Changes in CEO cash compensation are related to a company's TRS.

- Companies' CEOs with higher total pay (cash compensation plus the value of stock options exercised) work at higher performing companies, as measured by TRS, than lower paid CEOs.

However, over the past years in the midst of the booming U.S. economy, it has been difficult to research and say with any certainty how CEO compensation would change in a declining stock market. We now can answer that question.

Given the lower financial performance of companies and the decline in the stock market in 2000, we would expect CEO pay to decrease from the prior year. In fact, our research did show that the median total CEO pay in 2000 of $1.3 million was lower than the $1.9 million received in 1999, a decrease of 32 percent.

The reason for the decrease was that, with lower share prices and lots of stock options underwater, many executives had little or no gain and therefore exercised fewer options. Given the existing economic conditions in the U.S. and the expected performance of the stock markets through the latter half of 2001, we suspect that total CEO pay in 2001 will be lower still. Clearly, there is an element of risk and uncertainty in executive pay.

Nonetheless, we expect that executive pay programs will be a significant factor in a faster economic recovery than would otherwise occur. With so much of an executive's wealth and opportunity for pay tied to a company's stock, management has the necessary incentive to make required adjustments to business strategy and operations quickly to ensure the firm's survival during the downturn and position to make a strong recovery. Should senior management, especially CEOs, fail to make required adjustments, they risk being removed by dissatisfied shareholders and their boards.

Certainly stock options alone are no panacea. While they provide executives with high pay opportunities, in large quantities they can lead to excessive dilution. Our own research on overhang (options already granted plus those remaining to be granted, divided by total shares outstanding) indicates that there is a "sweet spot" for overhang that maximizes TRS, and that companies with high overhang relative to other firms within their industry have lower TRS. While Watson Wyatt believes stock options can work well, creating executive stock ownership is also essential.

Prognosis for 2002

Two years ago Watson Wyatt made a prognosis for the third millennium: While compensation opportunities, especially stock option grants, would continue to grow, actual payouts would most likely go down if the stock market corrected. On this prediction, we got it right. The longstanding criticisms of executive compensation are not going to go away. While specific abuses in pay programs are likely to be found, overall, the market for highly talented executives seems to be efficient. There does appear to be a relationship between pay and performance.

We predict that pay levels will continue to move with company financial and stock market performance. Annual bonuses and stock option profits will be much lower for 2001, when the data are reported in the spring of 2002. Stock incentive opportunities, especially stock options, will also start to level off as investors continue to raise concerns about excessive overhang.

However, for those companies that get their pay right, the returns could be excellent.

2002 STUDY OF CEO PAY AND PERFORMANCE

Figure 1 We studied more than 1,350 large public companies to determine the relationship between executive stock ownership (excluding stock options) and company performance. To do so, we split these companies into high- and low-CEO ownership based upon stock owned at the beginning of 2001. CEOs who were placed in the high ownership group had a median ownership stake of about $30 million, whereas the median holdings of CEOs in the low ownership group was just $1.8 million.

FIGURE 1: Executive Stock Ownership and Company Performance

	2001 CEO Stock Ownership ($ Millions)	Ownership to-Salary Multiple	2001 Stock Ownership Next Four Executives ($ Millions)	One-Year TRS	ROE	ROA	One-Year EPS Growth	Tobin's Q
High	$30.0	51.6:1	$3.3	20.7%	14.9%	5.3%	17.6%	1.4
Low	$ 1.8	3.4:1	$0.6	0.0%	11.7%	3.9%	10.7%	1.0
All	$ 7.0	11.1:1	$1.3	11.0%	13.4%	4.4%	14.2%	1.1

The Ownership-to-Salary Multiple
CEOs with high stock ownership had a median ownership-to-salary ratio that was more than 15 times greater than the ratio of CEOs with low ownership.

Return on Equity (ROE), Return on Assets (ROA), One-Year Earnings per Share (EPS) Growth
High CEO ownership was associated with superior corporate financial performance in 2000, as measured by ROE, ROA and EPS growth.

One-Year Total Return to Shareholders (TRS)
Companies having CEOs with high stock ownership yielded higher TRS than those with low ownership. Companies with high CEO ownership realized a total return of more than 20 percent for their shareholders at the median, while low ownership companies saw no return on their investment (for the 12 months ending December 2000).

2001 Stock Ownership Next Four Executives
Our research indicates that the median ownership of other named executives (the average ownership among the second through fifth most highly compensated executives) in companies with high CEO ownership is $3.3 million. This is more than five times higher than those companies in the low ownership group. Our results show that companies with high ownership CEOs extend the high ownership levels below the top position.

About The Survey

Our report on executive pay is based on two recent studies of top management compensation conducted by Watson Wyatt.

The first is the *CEO Pay Study*, which looked at compensation levels of CEOs at over 1,350 large public companies as reported in their FY 2001 proxy statements.

- Our analysis showed a strong, positive relationship between company performance and executive compensation levels, and is consistent with our results in previous years.
- We found that shareholder returns were significantly higher in companies with higher levels of executive stock ownership.
- Companies whose CEOs had higher pay opportunity, as measured by their Total Direct Compensation over five years, had higher total returns to shareholders (during the same period) than those with CEOs with lower pay opportunity.

The second study is Watson Wyatt Data Services' *2001/2002 Survey of Top Management Compensation*. This survey incorporates the results from over 13,500 executives at more than 1,700 companies and provides a broader perspective in current executive pay levels and recent trends in compensating top management. The survey's results indicate that:

- Executives at U.S. companies received an average increase of 6.2 percent in base salary and 10.3 percent in total cash compensation relative to the prior year.
- The average grant value of stock options to the CEO increased to $4.3 million in 2001, from $4.0 million in the prior year.
- The number of companies with stock ownership guidelines for their senior management group appears to have leveled off in the last few years, at about 26 percent.

KEY TERMS:

Grant Value: Number of Options x Exercise Price

TCC: Total Cash Compensation = Base Salary + Bonus

TDC: Total Direct Compensation = Total Cash Compensation + Present Value of Long-Term Incentives (Grants of Stock Options, Restricted Stock, Performance Shares, Etc.)

Tobin's Q: $\frac{\text{[Stock Market Valuation + Long-Term Debt]}}{\text{Replacement Cost of Assets}}$

A Tobin's Q of 1.0 indicates that a company is valued at the replacement cost of its assets. Values above 1.0 imply that the market sees the company as more valuable than the sum of its assets.

TRS: Total Return to Shareholders = $\frac{\text{[Stock Price Appreciation + Dividends]}}{\text{Beginning Stock Price}}$

Tobin's Q

Our research found that the Tobin's Q (see Key Terms) of companies having high CEO ownership is 40 percent higher than those led by CEOs with lower stock ownership. It appears that investors are willing to pay a premium for companies where senior management and shareholders interests are aligned.

Figure 2 We divided our database into companies with CEOs who received higher than median total compensation in 2000 and those with CEOs below median total compensation. Among the 1,200 companies studied, we found that performance was significantly better at companies with high actual CEO pay.* Since the majority of CEO pay is delivered through stock options, we conclude that companies are directly linking executive and shareholder interests. While it is impossible to say that the opportunity for higher pay caused better performance, it stands to reason that there is a causal relationship.

FIGURE 2: High CEO Pay Correlates With High Corporate Performance

	Total Actual CEO Pay — Median ($ Millions)	5-Year Annualized TRS
High	$3.0	17.6%
Low	$0.7	5.7%
All	$1.3	11.8%

* Actual Pay = Base salary + annual bonus + profit from stock options exercised

FIGURE 3: Changes in Cash Compensation Are Sensitive to Market Performance

	Percentage Change TCC	5-Year Annualized TRS
Above Median	32.9%	14.2%
Below Median	-5.8%	9.2%
All	9.3%	12.0%

Figure 3 CEOs with above median increases (1999–2000) in their Total Cash Compensation (TCC) had a five-year annualized TRS of 14.2 percent at the median, while those CEOs below the median saw their TCC decrease by almost 6 percent and had a return of just 9.2 percent. Annual increases in TCC appear to be related to a company's stock performance.

Figure 4 We compared the TDC (see Key Terms) of CEOs from 1996 through 2000 with their company's five-year annualized TRS. TDC is the best measure of future compensation opportunity. Therefore, we expect that TDC over the past five years to be correlated with subsequent stock market performance. We found that CEOs with above median TDC had a TRS nine percentage points higher than CEOs paid below the median.

FIGURE 4: 5-Year Cumulative CEO Pay Opportunity and Total Return to Shareholders

	5-Year Total CEO Pay Opportunity ($ Millions)	5-Year TRS*
High	$23.2	17.0%
Low	$ 6.1	7.9%
All	$11.6	11.9%

* TRS — Median Values

Figure 5 The Tobin's Q of high-ownership companies in 1996 is almost 15 percent greater than those led by lower ownership CEOs. It seems that investors are willing to pay a premium for a company if senior management has their long-term interests aligned with those of the shareholders.

FIGURE 5: Investors Paid a Premium for High CEO Stock Ownership Companies

	CEO Stock Ownership in 1996 ($ Millions)	Current Tobin's Q
High	$19.2	1.17
Low	$ 1.1	1.02
All	$ 5.2	1.08

FIGURE 6: CEO Stock Ownership Is Correlated to Long-Term Corporate Performance

	5-Year Annualized TRS	1996 Stock Ownership ($ Millions)
High	22.0%	$7.0
Low	1.1%	$3.5
All	10.9%	$5.3

Figure 6 Our research showed that higher performing companies, as measured by five-year annualized TRS, had CEOs that owned nearly twice the value of the company's stock in 1996 than low-performing companies.



Summary of Statistical Findings from the 2001/2002 Survey of Top Management Compensation

Cash Compensation

- Base salaries of "matched executives" increased by 6.2 percent in 2001, consistent with increases in the previous two years.
- For the third year in a row, the largest salary increases (7 percent) occurred among executives in the Retail and Wholesale Trade industry.
- The average increase in Total Cash Compensation (TCC) was 10.3 percent, an increase from 7.8 percent in the prior year. The largest increases in TCC occurred among executives in nondurable goods manufacturing (14.5 percent).
- Sixty-nine percent of executives received annual bonuses in 2001, slightly higher than in 2000.
- The average bonus paid was 38.7 percent of base salary while the average target was 35.5 percent, indicating that overall performance was above expectations.

Stock Option Programs

- In 2001, 16 percent of all employees were eligible for stock options.
- CEOs received stock options with an average grant value equal to $4.3 million, or about 6.6 times their annual salary. This multiple for CEOs increased from an average of 4.9 over the prior 3 years.
- Stock option grant value multiples (of base salary) ranged from 1.4 to 5.3 for top management positions below the CEO. The average multiple for these 10 selected positions was 2.6, an increase from 2.2 in 2000.
- Companies had an average stock option overhang of 13.9 percent of their total shares outstanding, a significant increase from 12.6 percent in 2000.
- Consistent with previous years, approximately one-third of all stock options granted to employees in the last year were granted to the top five executives.

WATSON WYATT 2001/2002 SURVEY OF TOP MANAGEMENT COMPENSATION

FIGURE 7: Characteristics of Participating Organizations

Total Number of Executive Positions	13,520	
Total Number of Organizations	1,741	
Industry Sector	Number of Responses	Percentage of Responses
Banking and Finance	80	4.6%
Durable Goods Manufacturing	435	25.0%
Health Care	98	5.6%
Insurance	117	6.7%
Nondurable Goods Manufacturing	228	13.1%
Retail and Wholesale Trade	97	5.6%
Services	590	33.9%
Utilities and Energy	96	5.5%
All Sectors Combined	**1,741**	**100.0%**
Revenue Size	Percentage of Responses	
Under $100 Million	23%	
$100 Million to $1 Billion	46%	
Above $1 Billion	31%	

FIGURE 8: CEO Compensation: Average Compensation by Revenue Size and Industry

Revenue Size	Salary	Bonus	Bonus as Percent of Salary	TCC	Stock Option Grant Value
Below $100 Million	230.3	100.2	43%	304.0	485.0
$100 Million to $499 Million	380.5	244.9	58%	566.1	947.7
$500 Million to $1 Billion	483.6	336.3	69%	766.4	1,805.8
Above $1 Billion	722.7	685.5	91%	1,356.6	5,620.1
Industry					
Banking and Finance	454.3	372.9	67%	825.4	2,422.1
Durable Goods Manufacturing	434.9	370.3	74%	726.8	1,917.6
Health Care	497.3	503.2	65%	943.8	4,305.0
Insurance	653.4	790.0	88%	1,283.5	1,832.3
Nondurable Goods Manufacturing	467.3	319.3	60%	755.4	2,224.7
Retail and Wholesale Trade	606.3	444.7	72%	983.7	8,375.3
Services	430.7	332.6	63%	684.6	2,117.4
Utilities and Energy	644.5	781.4	88%	1,338.3	5,625.9
All Industry Sectors	**490.0**	**427.4**	**66%**	**843.8**	**2,970.3**

Figure 8 CEOs had an average base salary of $490,000 with a grant value of stock options equal to six times their salary. However, CEOs at companies with more than $1 billion in revenues received salaries that were more than three times higher than the salaries of CEOs at companies with less than $100 million in revenue. The CEO position is highly leveraged, with those at large companies having more compensation "at risk" than CEOs at smaller companies.

FIGURE 9: Other Executives Compensation: Average Compensation by Position — All Industries

Position	Salary	Bonus	Bonus as Percent of Salary	TCC	Stock Option Grant Value
Chief Operating Officer	327.2	271.1	60%	545.4	2,211.0
CEO/President — Subsidiary	291.1	166.3	56%	425.7	1,283.0
Top Operations Executive (Nonmanufacturing)	156.2	60.5	31%	200.8	457.0
Top Human Resources Executive*	153.8	59.9	28%	202.6	305.0
Information Technology/MIS Executive	158.3	61.6	32%	208.7	403.0
Top Legal Executive	215.4	113.9	45%	316.0	733.0
Top Marketing ard Sales Executive	168.4	78.2	39%	228.9	324.0
Chief Financial Officer/Top Financial Executive	234.9	133.0	48%	345.4	976.0
Top International Executive	217.4	112.8	48%	303.5	636.0
Top Manufacturing/Production Executive	142.9	57.6	35%	194.9	257.4

* Without labor relations

Figure 10 Top management positions had larger increases in TCC than in base salaries during 2000, indicating that companies are continuing to place greater emphasis on performance-based cash compensation. This finding is consistent with results in previous years.

FIGURE 10: Percentage Change in Salary and Total Cash Compensation By Position — All Industries

Position	Base Salary	Total Cash
Chief Executive Officer	5.2%	15.6%
Chief Operating Officer	6.1%	23.3%
CEO/President — Subsdiary	8.1%	10.0%
Top Operations Executive (Nonmanufacturing)	7.1%	10.1%
Top Human Resources Executive*	7.1%	10.1%
Top Information Technology/MIS Executive	6.9%	9.6%
Top Legal Executive	6.3%	11.5%
Top Marketing and Sales Executive	6.2%	16.8%
Chief Financial Officer/Top Financial Executive	7.1%	11.3%
Top International Executive	8.9%	10.8%
Top Manufacturing/Production Executive	5.7%	11.7%

* Without labor relations

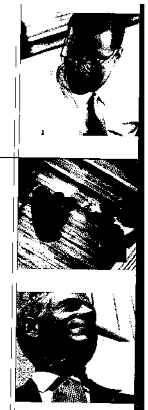


FIGURE 11: Percentage Change in Salary and Total Cash Compensation By Industry -- All Executive Positions

Industry Sector	Base Salary	Total Cash
Banking and Finance	6.8%	8.4%
Durable Goods Manufacturing	5.8%	9.6%
Health Care	5.5%	8.9%
Insurance	6.8%	10.8%
Nondurable Goods Manufacturing	6.1%	14.5%
Retail and Wholesale Trade	7.0%	12.6%
Services	5.9%	7.7%
Utilities and Energy	6.5%	11.6%
All Industry Sectors	**6.2%**	**10.3%**
3 Year Analysis	Base Salary	Total Cash
1998–1999	6.4%	11.4%
1999–2000	5.8%	7.8%
2000–2001	6.2%	10.3%

Figure 11 Salaries of executives increased by 6.2 percent in 2001 compared to 5.8 percent in 2000. Total Cash Compensation increased by 10.3 percent in 2001, an increase from 7.8 percent in 2000. The largest increases occurred in the retail, utility and nondurable goods manufacturing industries.

FIGURE 12: Average Budgeted Merit Increases — By Employee Group

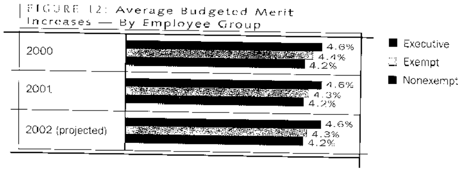


Figure 12 The average projected merit increases for 2002 are identical to those that were actually made in 2001. These modest increases indicate that salaries, a fixed cost, continue to experience slow growth while companies have placed more emphasis on performance-based pay.

Figure 13 Employees with higher salaries generally received larger bonuses as a result of having higher levels of performance-based pay. Sixty-nine percent of executives actually received a bonus in 2001, an increase from 66 percent last year. The average bonus paid for all positions was 38.7 percent of salary. Overall, actual bonuses were 109% of target, indicating that company results exceeded expectations.

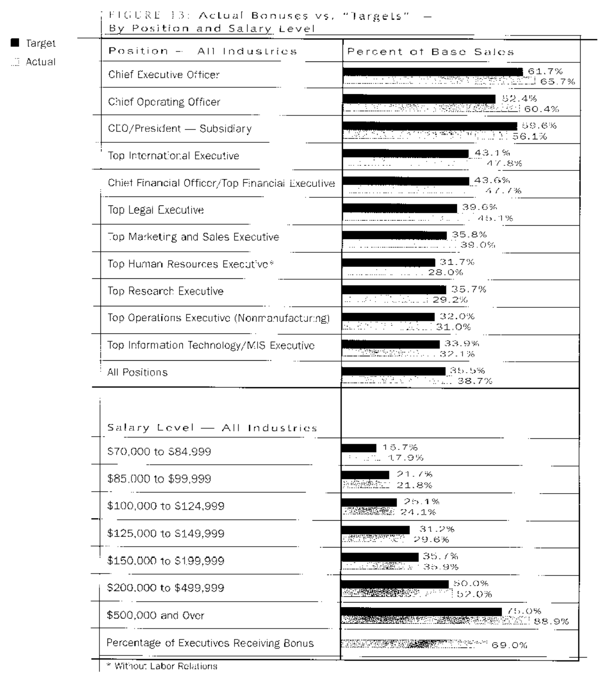
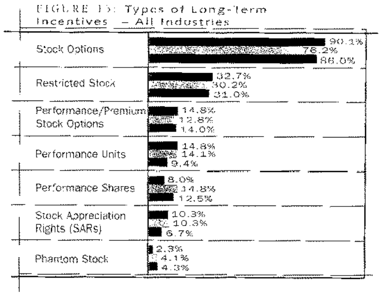


FIGURE 14: Performance Measures Used in Determining Annual Incentives — All Industries

Performance Measure	Percentage of Companies
Annual Sales/Revenues	43.5%
Net Profits After Taxes	29.4%
Operating Income	28.9%
Customer Satisfaction	19.4%
Service/Quality	16.3%
Earnings per Share	15.6%
Return on Equity	11.9%
Return on Assets	10.4%
Other	42.7%

Figure 14 Firms use a variety of financial and operational measures in which to measure company performance. This year's results are consistent with those from last year, and show a continued increase in the use of performance measures that focus on the customer such as service/quality and customer satisfaction.

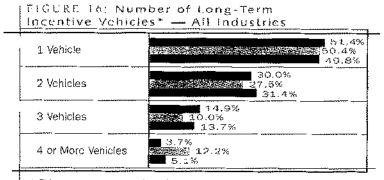
FIGURE 15: Types of Long-Term Incentives — All Industries



■ 2001/2002
□ 2000/2001
■ 1999/2000

Figure 15 Stock options remain the predominant long-term incentive vehicle, followed by restricted stock. The use of phantom stock among survey participants has continued to decline, from 7.8 percent of companies in 1998 to just 2.3 percent in 2001.

FIGURE 16: Number of Long-Term Incentive Vehicles* — All Industries



* This represents the number of grant types (stock options, restricted stock and performance units) even if clustered onto one plan.

■ 2001/2002
□ 2000/2001
■ 1999/2000

Figure 16 Approximately 50 percent of companies use more than one long-term incentive vehicle. About 19 percent of companies use three or more forms of long-term incentives.

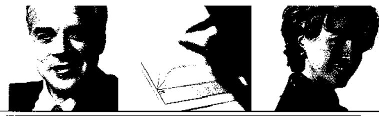


FIGURE 17. Stock Option Grant Values By Position and Salary Level — All Industries

Position	Grant Value	Base Salary	Multiple 2001–2002	Multiple 2000–2001	Multiple 1999–2000
Chief Executive Officer	$4,301.0	$596.6	6.6	4.8	5.0
Chief Operating Officer	$2,211.0	$413.6	5.3	2.9	3.4
CEO/President — Subsidiary	$1,283.0	$342.3	3.4	2.5	2.4
Chief Financial Officer/ Top Financial Executive	$ 976.0	$287.5	3.1	2.4	2.5
Top Legal Executive	$ 733.0	$241.2	2.6	2.3	2.1
Top International Executive	$ 636.0	$253.4	2.1	2.7	2.7
Top Human Resources Executive*	$ 305.0	$162.3	1.8	2.0	1.5
Top Information Technology/ MIS Executive	$ 403.0	$186.9	1.8	1.5	1.5
Top Marketing and Sales Executive	$ 324.0	$200.7	1.4	1.9	1.3
Top Research Executive	$ 432.0	$175.7	2.2	1.2	1.0
Top Operations Executive (Nonmanufacturing)	$ 457.0	$212.0	1.8	2.8	2
Salary Level	**Grant Value**	**Base Salary**	**Multiple 2001–2002**	**Multiple 2000–2001**	**Multiple 1999–2000**
$70,000 to $84,999	$ 53.0	$ 78.4	0.7	0.6	0.7
$85,000 to $99,999	$ 58.0	$ 92.2	0.6	1.3	1.1
$100,000 to $124,999	$ 94.0	$112.0	0.8	1.3	1.1
$125,000 to $149,999	$ 150.0	$136.1	1.1	1.1	1.1
$150,000 to $199,999	$ 273.0	$170.5	1.6	1.6	1.5
$200,000 to $499,999	$ 874.0	$279.3	3.0	2.7	2.6
$500,000 and Over	$4,763.0	$683.1	6.9	5.6	5.9

* Without Labor Relations

Figure 17 Executive positions with greater responsibility and accountability tend to receive compensation packages that are more highly leveraged with stock option grants. In 2001, participants reported an increase in stock option grant levels to their most senior executives while grants to lower level executives appear to have leveled off in the last three years. Executives with salaries over $500,000 received stock options with an average grant value of 6.9 times their annual salary, while those with salaries between $85,000 and $100,000 received options equal to 70 percent of their base salary.

FIGURE 18: Stock Option Eligibility — By Industry

Industry Sector	Percentage of Employees Eligible	Average Salary of Lowest Paid Eligible Employee ($000)
Banking and Finance	11.2%	$68.5
Durable Goods Manufacturing	15.3%	$66.8
Insurance	11.2%	$70.7
Nondurable Goods Manufacturing	13.5%	$63.6
Retail and Wholesale Trade	6.4%	$71.9
Services	21.6%	$61.5
Utilities and Energy	23.9%	$73.3
All Industries*	**16.0%**	**$66.2**

* Excludes Health Care and Nonprofits

Figure 18 The percentage of employees eligible for stock option grants appears to have leveled off over the last two years, from 16.9 percent last year to 16.0 percent this year. Companies across all industries continue to use stock options as a means of compensating many employees.

FIGURE 19: Stock Option Grants — Years Until 100 Percent Vesting

Vesting Period	Percentage of Plans
1 year	4.8%
2 years	3.5%
3 years	40.3%
4 years	23.4%
5 years	22.5%
More than 5 years	5.6%

Figure 19 More than 85 percent of companies incorporate three- to five-year vesting on stock option grants, with three years being the most common.

FIGURE 20: Executive Stock Ownership Guidelines — By Industry

Industry Sector	Percentage of Companies
Durable Goods Manufacturing	30.2%
Nondurable Goods Manufacturing	19.3%
Retail and Wholesale Trade	36.4%
Services	20.9%
Utilities and Energy	25.0%
Banking and Finance	32.0%
Insurance	29.4%
All Industries	25.8%

Figure 20 The number of companies establishing executive stock ownership guidelines appears to have leveled off over the last couple of years. In 2001, 25.8 percent of companies surveyed reported having ownership guidelines.

FIGURE 21: Basis for Determining Executive Stock Ownership Guidelines — All Industries

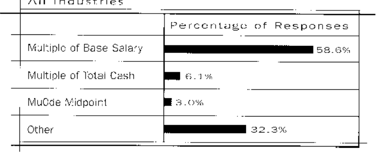


Figure 21 Most companies continue to use a multiple of the base salary as the basis for executive stock ownership guidelines.

FIGURE 22: Stock Ownership Guidelines — Average Multiple of Base Salary

Position	2001/2002	2000/2001	1999/2000
Chief Executive Officer	4.9	4.5	4.3
Next Four Executives	2.9 – 3.2	2.8 – 3.1	2.4 – 2.9

Figure 22 CEOs and other named executive officers have stock ownership guidelines ranging from 2.8 to 4.5 times their base salaries, on average.

FIGURE 23: Overhang and Shares Granted to Top Five Executives

Industry Sector	Average Share Overhang from Stock Options Programs as Percentage of Total Shares Outstanding	Stock Options Granted to Top Five Executives as a Percentage of Total Shares Granted to All Employees
Banking and Finance	12.3%	37.3%
Durable Goods Manufacturing	14.5%	37.7%
Insurance	7.1%	40.3%
Nondurable Goods Manufacturing	10.9%	38.5%
Retail and Wholesale Trade	14.8%	25.6%
Services	18.1%	25.6%
Utilities and Energy	10.3%	41.5%
All Industries	**13.9%**	**35.4%**

Figure 23 In 2001, the average overhang among companies surveyed increased significantly to 13.9 percent of total shares outstanding from 12.6 percent in 2000. Consistent with results from previous years, companies granted about one-third of all options granted to their top five officers.

Managing Stock Option Overhang in Today's Economy

The 2002 Study

W W W . W A T S O N W Y A T T . C O M

Watson Wyatt

INTRODUCTION

Stock options for executives and all employees have become highly controversial over the past two years. Clearly, stock options helped drive the extraordinary 10-year bull market that recently — and abruptly — ended. It also appears that stock options — given their motivational power — could help end the current bear market and recession. However, potential dilution levels, as measured by overhang (options already granted plus those remaining to be granted divided by total shares outstanding), are higher than ever, and a very large percentage of those options is underwater.

To understand the impact of stock options, it is important to note that they have two countervailing effects:

- **Incentive Effect:**
  Stock options motivate employees to create superior financial performance, placing upward pressure on stock prices.
- **Dilution Effect:**
  Stock options represent a potential future issuance of shares, creating dilution, putting downward pressure on stock prices.

The overall effect of a stock option grant on a firm's value depends on numerous factors, including the overall size of the grant, the condition of the stock market, the company's performance, the internal culture of the company and levels of employee stock ownership. Boards of directors must be sensitive to these issues as they determine how many shares of stock and stock options to issue.

This report answers a number of key questions:

- Are shareholders getting their money's worth from such high levels of overhang?
- Is overhang continuing to rise? Why is overhang rising?
- Are all companies raising their overhang?
- Is there an optimal overhang level for different companies and industries?
- What can boards of directors do to manage overhang?
- What does the future hold for overhang?

KEY FINDINGS

- Stock options remain a positive factor on company and economic performance, despite recent market corrections.
- Overhang from stock options rose to 14.6 percent in 2000, a substantial increase from 1999.
- This reverses a five-year slowing trend in overhang growth, partly explained by:
  - A constant annual grant (or run-rate) of new options, combined with
  - A collapsing exercise rate of old options due to the various market corrections since spring 2000.
- Despite the rising average overhang, more than 50 percent of companies reduced their overhang during 2000.
- There are substantial differences in overhang levels by industry. Technology and health care have much higher levels than others.
- There is an "optimal" overhang level by industry:
  - This optimal level is associated with superior returns to shareholders.
  - For **most** companies and industries, this optimal level is well below their **actual** overhang levels.
  - This finding on optimal overhang appears to work in both bull **and** bear markets.
- There are several effective techniques for managing overhang levels, especially increasing real stock ownership.

TABLE 1: Stock Option Overhang and Stock Market Performance in the 1990s

	Dow Jones Industrial Average	Overhang
1990	2,634	5.4%
1995	5,117	9.2%
1997	7,908	11.9%
1999	11,497	13.0%
2000	10,787	14.6%
10-year Annualized Growth Rate	**15.1%**	**10.5%**

OUR STUDY METHODOLOGY

All of the data used in this study have come from publicly available databases. Data on stock option overhang are from the Investor Responsibility Research Center (IRRC). They provide an annual study of stock option overhang, most recently *Potential Dilution at S&P Super 1,500 Companies in 2000* by Annick Siegl. Standard and Poor's (S&P) Execucomp database was used for information on the stock ownership and stock option grants to Top Five Executives. Information on shareholder returns, market values and other financial data are from S&P's Compustat North America databases.

Financial and executive compensation information was matched with the overhang numbers for firms that were in the IRRC database in 1999 and 2000. This resulted in a sample of more than 980 firms. Some of the analysis required additional performance or historical data, which was not available for all firms, resulting in slightly smaller sample sizes. Where industry comparisons are made, firms were assigned to their industry based on their economic sector as defined in the IRRC report.

ANSWERING THE QUESTIONS

Has the increased use of stock-based incentive compensation been good for U.S. equity markets?

In general, yes. At the start of the decade, the average level of stock option overhang for a firm in the S&P 1500 was 5.4 percent, while the S&P 500 stood at 353 (see Table 1). Even after a significant decline in 2000 and the first eight months of 2001, the S&P 500 was still at 1,134, having increased at an annual rate of 11.6 percent. During this period, the Dow Jones Industrial grew at an annual rate of 10 percent. Between 1994 and the end of August 2001, the S&P 1500 had risen by 147 percent, an annual rate of 14.5 percent. During this same period, the average stock option overhang at the S&P 1500 has risen to 14.6 percent, increasing at an annual rate of 11.7 percent.

There are many factors responsible for the increase in the stock market and corporate earnings during this period, including globalization, low interest rates, the revolution in communications brought about by the Internet and increased savings by baby boomers preparing for retirement. However, evidence supports the hypothesis that the use of stock-based incentive compensation has helped drive the increase in stock market performance. As executives, and to an increasing extent all employees, have acquired greater stakes in a firm's stock performance, they have begun to act more like owners, to the benefit of shareholders at large. But we believe that there is also some evidence to indicate that **excessive** use of options at some companies has contributed to the recent stock market decline.

Is there a difference in overhang level by industry?

Yes, there are substantial and persistent differences in overhang levels by industry. The highest overhang firms are still in the technology and health care industries, while the lowest levels are reported in utilities and energy (see Table 2). These are also the same industries with the highest and lowest levels of overhang in 1999. The differences do not simply reflect an unreasonable preference for option usage in certain industries or a mindless desire to keep up with the Joneses. Instead, they are driven by real differences between industries in the level of R&D Intensity, the importance of advertising, the relative capital intensity of production and especially the nature of the human capital employed. For technology specifically, the high average overhang reflects large grants made during the heat of the talent crisis. As we will see, firms that ignore these differences and set overhang levels too high or too low relative to their industry tend to perform poorly relative to their peers.

What has happened to the rate of overhang growth?

Between 1997 and 1999, the rate of overhang growth declined (see Table 3). Although average overhang rates continued to rise as firms adopted more broad-based stock option incentive programs, many firms hit high overhang levels. These levels were high enough to cause them to worry about significant shareholder resistance to any further increases due to fears of excessive dilution.

The rate of overhang growth, which had begun to slow between 1997 and 1999, resumed a double-digit growth rate between 1999 and 2000. Unlike the earlier period of rapid growth in overhang rates, which coincided with a rising stock market, this increase in the growth rate in overhang came during a period of declining stock markets. In fact, a major reason for the most recent rise in overhang is that employees are exercising far fewer stock options.

Over the past decade, a typical company granted stock options with a run-rate (options granted as percent of shares outstanding) in the 2 to 3 percent range. Exercises had been in the 1 percent range, yielding a net long-term increase in annual overhang of 1 to 2 percent. If exercise falls toward 0, net overhang will rise 2 to 3 percent. This is indeed what happened recently.

TABLE 2: 2000 Overhang Levels by Industry

Industry	Overhang Level
Technology	24.1%
Health Care	18.3%
Consumer Cyclicals	15.2%
Transportation	14.5%
Communication Service	14.1%
Consumer Staples	13.5%
Basic Materials	12.9%
Capital Goods	12.8%
Financials	12.4%
Energy	9.5%
Utilities	6.5%
Total	14.6%

TABLE 3: Annual Overhang Growth Rates and S&P 500 Performance Over Time

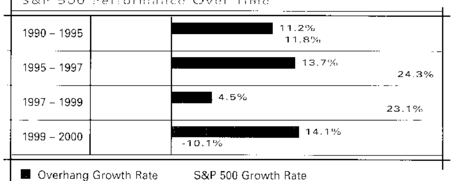


TABLE 4: Change in Overhang and Overhang Levels by 1999 Industry-Adjusted Overhang Level

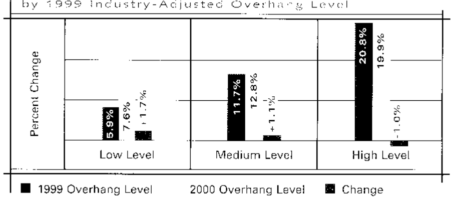


TABLE 5: Overhang Levels for Firms That Increased Overhang and Firms That Decreased Overhang Between 1999 & 2000

	Overhang Decreasers			Overhang Increasers		
	n	1999	2000	n	1999	2000
Basic Materials	30	10.8%	9.9%	36	9.8%	13.9%
Capital Goods	56	12.8%	10.7%	47	10.1%	13.2%
Communication Service	5	8.9%	7.4%	2	14.6%	20.2%
Consumer Cyclicals	71	15.1%	12.7%	83	13.3%	17.0%
Consumer Staples	39	10.0%	8.6%	34	10.7%	14.8%
Energy	23	10.9%	8.8%	19	7.1%	9.7%
Financials	51	14.7%	11.2%	34	9.6%	13.0%
Health Care	31	17.5%	14.9%	23	13.6%	17.6%
Technology	34	23.3%	20.6%	36	20.0%	24.7%
Transportation	13	16.3%	14.4%	14	10.9%	14.9%
Utilities	24	6.0%	4.3%	30	4.9%	7.8%
Total	**377**	**13.9%**	**11.7%**	**358**	**11.5%**	**15.2%**

n = Number of Firms in Sample

Are all firms increasing their overhang?

This increase has not been uniform. Firms with relatively low overhang, when compared to their industry peers, increased their overhang levels substantially, while firms with overhang levels that were high relative to their industry peers actually tended to reduce their overhang levels (see Table 4). Although this may be caused by simple reversion to the mean, this evidence is also consistent with our hypothesis that there are optimal overhang levels for each company and industry, depending on the characteristics of the firms within that industry, and that firms are managing their overhang levels to find the "sweet spot" where they can achieve superior performance.

Slightly more than 50 percent of the firms in our sample actually decreased their overhang levels in 2000 (see Table 5). Overhang-decreasing firms tended to have higher overhang levels in 1999 than their industry peers, who increased their overhang levels. This pattern holds true across all industries. The percentage of firms within an industry that decreased their overhang levels varied from a low of 44 percent in the utilities industry to a high of 60 percent of financial firms (this excludes the small sample of communication service companies). Nevertheless, the "increasers" raised their overhang levels more than the "decreasers" reduced theirs, thereby causing the average to rise significantly.

Why has the growth in overhang rates increased again?

As seen in Table 3, this recent upsurge in the overhang growth rate coincided with a declining stock market. Therefore, we believe that much of the increase in overhang rate growth is attributable to reduced rates of option exercise in 2000 caused by the declining market. One sign that points to this conclusion is that the firms with the lowest growth in overhang between 1999 and 2000 (relative to their industry peers) had the highest TRS in 2000. These firms also were likely to have the greatest share of overhang reducing stock option exercises.

Does this merely prove that overhang levels are driven by performance rather than overhang being an important driver of performance?

No. Although high-performing firms will have more options exercised, there is also evidence that **prior** overhang actually drives **subsequent** superior performance. In Watson Wyatt's 2001 study, *Stock Option Overhang: Shareholder Boon or Shareholder Burden?*, we illustrated that a firm's optimal overhang level depended on the capital intensity of its production and R&D intensity. These characteristics tend to be similar across all firms in an industry. Based on a regression analysis of performance and prior years' overhang levels, we were able to show that overhang levels are a leading indicator of stock market performance.

Is there an optimal overhang level?

Using that same model, we determined an optimal level of overhang by industry that maximized returns to shareholders. In Table 7, we have grouped firms by their 1999 overhang levels, compared to the optimal levels for their industry, and looked at their TRS in 2000. We divided our analysis into three industry sectors — technology, health care and others. Our previous analysis showed that the optimal overhang level for technology firms was about 25 percent; 17 percent for health care firms; and for other industries the optimal level was below 10 percent. **In all three cases, the optimal level of overhang is well below the highest levels, and in two cases, below the median.** This indicates that stock options are a scarce resource and need to be allocated wisely.

The year 2000 was particularly difficult for technology firms (the NASDAQ Composite Index lost about 40 percent during 2000) and this is reflected in our sample of technology firms, where all three subgroups earned negative TRS in 2000. However, the best performance was in the group whose 1999 overhang level was closest to the predicted optimal levels for technology firms. **This group lost less than 2 percent, while technology firms with high overhang levels above 29 percent lost almost 40 percent of their value in 2000.**

This phenomenon is not just limited to technology firms or firms in declining industries. The same pattern also holds for firms in the health care industry — an industry that enjoyed a banner year in 2000. The average TRS for firms that were at or near the optimal overhang level predicted by our model was more than 58 percent. Once again, the weakest performance (although still excellent) in 2000 was turned in by health care firms with 1999 overhang levels in excess of the predicted optimal level — in this case those with overhang above 19 percent.

This pattern also holds for firms in other industries where the predicted optimal overhang levels are lower than in either technology or health care. Firms that are closer to the overhang sweet spot have tended to outperform firms that are farther from the desired levels of overhang — especially those firms with overhang levels that are too high.

TABLE 6: Firm Performance vs. Growth in Overhang (1999 to 2000)

Overhang Growth	1999 Overhang	2000 Overhang	Difference in Overhang 99-00	2000 TRS
Low	16.1%	12.9%	-3.2%	16.7%
Medium	10.8%	10.9%	0.1%	13.3%
High	11.3%	16.5%	5.2%	11.4%

TABLE 7: 1999 Overhang Levels vs. 2000 TRS

Industry		1999 Overhang	1999 Overhang (avg)	2000 TRS
Technology	Low	Less than 21%	14.6%	-19.7%
	Medium	21% – 29%	26.0%	-1.7%
	High	Greater than 29%	39.2%	-39.5%
Health Care	Low	Less than 12%	8.4%	53.2%
	Medium	12% – 19%	15.3%	58.2%
	High	Greater than 19%	26.3%	48.3%
Others	Low	Less than 5%	2.5%	13.1%
	Medium	5% – 8%	6.7%	20.8%
	High	Greater than 8%	15.0%	13.2%

Do shareholders treat overhang composed mostly/entirely of underwater stock options more favorably than overhang composed mostly of in-the-money options?

We don't know, but probably not. This issue is whether out-of-the-money options are considered less dilutionary by shareholders than at-the-money or in-the-money options. The degree to which options are in- or out-of-the-money impacts both the incentive and the

TABLE 8: Run-Rates, Ownership and Stock Price Volatility by 2000 Industry-Adjusted Overhang Level

Overhang	2000 Overhang	2000 Run-Rate	Executive Ownership	Volatility
Low	6.7%	1.34%	0.87%	18.7%
Medium	13.1%	2.55%	0.78%	20.2%
High	23.3%	3.00%	0.48%	22.3%

Run-Rate = total stock options granted to all employees as a percentage of shares of common stock outstanding.

Executive Ownership = total shares owned by Top 5 executives as a percentage of shares of common stock outstanding.

TABLE 9: Average 2000 Run-Rates by Industry

INDUSTRY	2000 RUN-RATE
Technology	4.1%
Energy	3.3%
Health Care	2.5%
Consumer Cyclicals	2.3%
Transportation	2.2%
Communications	2.1%
Consumer Staples	1.9%
Basic Materials	1.8%
Capital Goods	1.8%
Financials	1.6%
All	2.5%

TABLE 10: Do High Overhang Companies Have High Run-Rates?

	Low	Medium	High
1999 Industry-Adjusted Overhang	1.3%	1.8%	2.2%
2000 Industry-Adjusted Overhang	1.4%	1.9%	3.1%

dilution effects. First, with regards to incentives, the deeper in-the-money an option is, the more it resembles ownership of a share of stock, leading to a better alignment with the interests of shareholders. This is consistent with academic research that has shown option grants with exercise prices near the current price have the greatest incentive effects per dollar value granted. Conversely, options that are significantly underwater have very little effect on retention and motivation. Further, from a purely technical accounting perspective (known as the "Treasury Stock Method"), out-of-the-money options are not dilutionary on EPS at all.

However, anecdotal and other research indicates that these highest overhang companies currently have the most underwater options. Therefore, given the results in Table 7, it appears that shareholders depress the stocks of companies with the highest overhang, regardless of the status (in- or out-of-the-money) of the options. We believe that if there were less of a penalty for out-of-the-money options, the results in Table 7 would be less dramatic.

Why is excessive overhang a problem?

Companies perform poorly for numerous reasons, but there are two main reasons why excessive overhang may contribute to poor performance. First, higher overhang represents greater potential dilution of shareholder interests. In addition, higher overhang levels allow for larger stock option grants, which may substitute for actual share ownership. In Table 8, we see the negative relationship between overhang and executive stock ownership and the positive relation between overhang and run-rates. The result is that while managers have strong incentives to increase the value of the firm's equity — the positive effect of providing stock-based incentives — they also may have incentives to take riskier actions because option values are increasing functions of the risk of the stock. In our previous study, we discussed the risk-increasing actions that managers can

take and demonstrated the relationship between the share ownership, the option holdings and these firm behaviors. Here, we show that high overhang companies do in fact have substantially higher share price volatility when compared to low or moderate overhang companies in the same industry (see Table 8).

Do run-rates vary by industry? Do high overhang companies have high run-rates?
Yes and yes. There is substantial variation in run-rate by industry, with technology and energy having the highest levels (see Table 9). Table 10 demonstrates that high overhang companies tend to arrive there via high levels of annual stock option grants. We assume these companies also go back to shareholders more frequently than average and ask for larger requests.

Another issue that has risen is whether total overhang (options granted plus options remaining) is less important to shareholders as a measure of potential dilution than solely options granted. The argument is that shareholders put less emphasis on the potential dilution from options remaining (since boards can reduce or eliminate future grants) and more on those already granted. In our experience, however, institutional investors and board members are indeed concerned about total overhang; in interviews, investors have told us that they assume all options authorized will be granted eventually.

In addition, research by academics and institutional investors shows that the number of options granted is highly correlated with the number of options remaining, meaning that companies with large amounts of already granted options tend to also have large amounts of options remaining to be granted. Therefore, total overhang is an acceptable and arguably the best single measure of potential dilution.

CONCLUSION

We believe there is strong evidence of an overhang sweet spot — the overhang level that best balances the incentive effects with the expected costs of dilution and increased volatility. Firms that have been close to this sweet spot have continued to outperform their industry peers. This is regardless of whether the economy is in a bull or bear market, and whether they are in industries such as technology, which experienced substantial declines in shareholder value, or in health care, which experienced a substantial increase in shareholder value, or somewhere in between.

Overall, we believe overhang will rise for the next year or two and then level off. But there

CREATING STOCK OWNERSHIP VIA A MANAGEMENT STOCK PURCHASE PLAN (MSPP)

An MSPP is a cost-effective way to encourage stock ownership by allowing executives to purchase company stock (with matching shares) on a pretax basis from income that would otherwise be paid as base salary or bonus.

With respect to plan design, purchases can be mandatory or voluntary, or a combination depending on executive stock ownership levels, firm culture, etc. Companies typically offer a 25 to 50 percent match, which appeals to executives and shareholders. Typical plan features include:

Eligibility — Limited to designated members of senior management.

Match — A 25 percent match on the fair market value on the date of purchase.

Mandatory Purchase — Participants could be required to use 25 percent of their bonus to purchase restricted stock.

Voluntary Purchase — Participants are usually allowed to make voluntary purchases beyond mandatory levels.

Restriction/Vesting — Purchases are usually restricted from sale for a period of three years.

The advantage of an MSPP to the employer is that restricted stock has predictable and controllable accounting costs. The extra cost is equal to the match at purchase, and it is spread over the restriction period. In addition, there are tax advantages to the employer.

are pressures in the marketplace that affect overhang — some positively and some negatively. The following list describes some of these pressures:

Upward Pressures on Overhang

- **Low exercise rates** — overhang is reduced when options are exercised. Until a high level of exercise begins again, overhang will continue to rise. This may be the dominant factor affecting overhang.
- **Shrinking Black-Scholes values** — declining stock prices put pressure on companies to increase grant sizes.

Downward Pressures on Overhang

- **Institutional investor/media reaction** — puts pressure on companies to reduce run-rates and new authorization requests.
- **Downward "ratchet" from declining competitive market values** — boards will level off grant sizes for all employees despite declining stock prices. This will eventually show up in compensation surveys as declining economic value.
- **CEOs have enough options** — many boards are starting to level off grant sizes.
- **Saturation of all employee grants** — many companies already include a large number of employees.
- **"Survivor bias" (elimination of dot-coms)** — as companies with high overhang disappear, the average will decline.
- **Stock option repricing/exchanges** — some options could disappear in the course of these transactions.
- **Layoffs** — laid-off employees typically have to exercise immediately. This would reduce overhang.

What Should Boards Do?

Boards of directors face several challenges in the stock option arena, including already high levels of overhang and many stock options that are underwater and have little retention or motivational power.

Obviously there is no simple solution to these controversial challenges. Stock options are an essential part of any corporation's compensation package, given their motivational power and favorable accounting treatment. However, excessive dilution and underwater options are the downside of those benefits.

Nevertheless, we believe that boards can address this problem by:

- **Creating more direct stock ownership**
  Real stock ownership has some advantages over options, including retention and changing behaviors. If shares are sold to employees (even with a match — see sidebar on page 7), their vesting can be highly retentive and can save shares. In addition, other Watson Wyatt research shows that high executive stock ownership, unlike overhang, yields superior returns to shareholders.
- **Reducing or leveling off grant sizes**
  Grant sizes, especially for top management, are probably already large enough to be motivational.
- **Exchanging underwater stock options for fewer restricted shares or restricted stock units**
  Despite the accounting impact, this type of an exchange reduces options granted. This most likely will not reduce overhang, but it is much more retentive than underwater options. It will, however, reduce or delay new requests to shareholders of stock option authorizations.
- **Using alternative stock-based incentives** (Performance Accelerated Restricted Stock, Performance Shares, etc.) **to trade off/reduce stock option grants.**

STATEMENT OF PROFESSOR KATHRYN J. KENNEDY
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Testimony Before the Senate Finance Committee
Hearing on Nonqualified Deferred Compensation Arrangements

April 18, 2002

I. Introduction

Chairman Baucas, Senator Grassley, and Members of the Committee, I am Kathryn J. Kennedy[1], a professor of law at The John Marshall Law School and the director of the school's graduate programs in taxation and employee benefits law. I am also a pension actuary with 25 years of experience in the employee benefits field. As director of the school's graduate programs in tax law and employee benefits law, I oversee a program dedicated exclusively to the study of employee benefits law, the *only* one of its kind in the nation. Presently, the curriculum offers 18 different employee benefits courses – ranging from executive compensation to health and welfare law to qualified retirement plans to employee stock ownership plans.

II Purpose of my Testimony

My purpose in giving this testimony is two-fold: to dispel the myth that nonqualified deferred compensation plans (NQDC plans) are providing some massive tax loop-hole for executives of privately-held corporations *and* to highlight legitimate concerns that Congress may wish to address in the NQDC area. My remarks are limited to privately-held corporations' NQDC plans, which are funded by neither employer stock nor split-dollar life insurance.

The best way to understand the tax effect of **nonqualified** deferred compensation plans is to understand what they are not – **qualified** deferred compensation plans (qualified under IRC §401(a)). Generally for compensation deferred for or by an employee, the employer's deduction must "match" the employee's inclusion of such amounts as taxable income in the same tax year.[2] By using a **qualified** retirement plan, the employer is permitted to *accelerate* this deduction to the earlier time when the contribution is made, while the employee defers taxation on the contribution and the tax-exempt earnings until actual distribution is made (which could be 20 to 30 years in the future).[3] Thus, Congress provides a substantial tax subsidy for deferrals made under **qualified** retirement plans, both for the employer and the covered employees.

Rank and file employees' deferred compensation is protected under qualified plans since they have exclusive rights to the plan assets and such rights may not be subject to forfeiture (except in the context of the qualified plan's vesting schedule). ERISA's funding and fiduciary rules assure that assets will be maintained for these plans and prudently invested by the plan fiduciary. There are legitimate policy reasons for providing such a subsidy for qualified plans. Savings for retirement is promoted, and employees are able to retire with sufficient retirement income. Also,

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it is possible that the improved general welfare actually strengthens the tax base while reducing pressures on the governmental safety net.

In contrast, when compensation is deferred under a NQDC plan, it may appear that the IRS is losing tax revenue because the employee is not presently taxed on such deferral. However, since the deferral is **nonqualified**, monies remain with the employer (until future distribution) and are taxed *presently* at the corporate tax rates. Any employer earnings on such deferrals are also taxed as earned.[4] In contrast with a qualified retirement plan where the plan assets must be held in a separate IRC §501(a) trust for the exclusive benefit of the participants, any assets used to informally fund a NQDC plan remain part of the employer's general assets.

The employee's taxation of such deferrals, if *properly* structured under a NQDC, is deferred until actual receipt of the payments. During this time span, the deferrals must remain subject to risk, thereby subjecting the employee to some type of potential loss or forfeiture until the payment is actually made.[5] To do otherwise will subject the employee to immediate taxation under the doctrine of constructive receipt, although actual receipt of the monies is delayed.

Thus, there is no massive tax loophole afforded by NQDC arrangements. The IRS is receiving tax presently at the corporate level on these deferrals and their earnings; taxation of the deferrals at the employee level is delayed as such deferrals are subject to risk until the time of actual payment. Indeed, the future taxability of the employee is offset by future deductibility to the corporation – approximately a "wash." The IRS receives its tax now, not later.

Why then do we have NQDC plans? There are legitimate reasons why such plans are so popular:

- For the executive, such plans provide for the gap at retirement between the level that can be provided under the qualified retirement plan and the replacement income level that is desired. Continued use of dollar limitations on deferrals under qualified plans (through compensation limits and maximum benefit/contribution limits)[6] created pressure to supplement the executive's retirement benefit. EGTRRA '01 increased those dollar limitations, but not significantly. These nonqualified arrangements also provide flexibility by permitting the executive to alter the timing of the receipt of such compensation thereby allowing the corporation continued use the employee's compensation during the period of deferral.

- For the corporation, a NQDC plan permits the actual *amount* of the executive's compensation to be dependent on future performance; acts as a retention device to keep executives by "handcuffing" them to the employer; serves as a recruitment device to hire mid-career executives who otherwise will lose benefits under their existing employer plans; and permits early retirement for current executives if desired. Qualified plans cannot achieve these objectives as vesting schedules are mandated by the Code, early retirement window benefits must be nondiscriminatory, and the level of plan compensation cannot be dependent upon future performance criteria.[7]

- There exists a slight tax arbitrage between the top corporate rate of 38% and the top individual rate of 38.6% (for 2002, but reducing to 35% by 2006). So the tax code has embodied a modest incentive to have income taxed sooner if at the corporate rate, or later if at the individual rate, but this will change as individual rates decrease in the future.

In order for the executive to delay taxation of deferrals under NQDC plans, certain tax rules must be satisfied.[8] These rules are set forth in the Internal Revenue Code and have been interpreted by the IRS and the courts. The Service's application of some of these rules, especially in regards to subsequent elections to alter the mode of distribution (*e.g.,* lump sum or installment), has been regarded as unduly restrictive,[9] whereas the courts provide greater latitude in providing for the alteration of the mode of payment.[10] As a result of the courts' hammering against the IRS' rulings, current guidance from the Service has been lacking, which certainly provides an environment for abuse.

III. Tax Rules Regarding Delayed Taxation of Income for Executives

The simplest nonqualified deferred compensation arrangement exists where the executive has an unfunded and unsecured promise by the employer to pay compensation at some future date in time. It is unfunded in the sense that no assets are set aside for the executive, and unsecured such that upon the employer's bankruptcy or insolvency, the creditors' claims come before the payment of the executive compensation. The actual date of the deferred payment to the executive under the NQDC plan can be negotiated (*for example*, termination of employment, death, disability, or retirement). Such arrangement avoids any immediate tax to the executive. It should be noted that there is a special timing rule applicable to NQDC plans for FICA tax purposes, which may treat the deferral differently for FICA purposes than for income tax purposes.[11]

Withdrawals: When – If the executive and the employer wish to permit withdrawal rights for the executive under the NQDC plan such that the executive can accelerate the payment of the deferrals to an earlier date, the Service requires that the withdrawal right be restricted or conditioned upon the occurrence of certain events.[12] The executive's unfettered right to withdraw deferred benefits would result in constructive receipt, thereby taxing him/her as if the payments were actually made, even though he/she chooses not to actually take the money.[13]

The Service has expressly approved of the following triggering events with no immediate adverse tax consequences for the executive: attainment of a certain age; becoming partially or totally incapacitated; completion of a certain period of service; termination of employment; reduction in hours worked from full-time to part-time;[14] change of control of the employer;[15] decrease of employer's net worth below $10 million;[16] or employer's liquidation.[17] Under the NQDC plan, if a triggering event occurs and payment is required by the employer to the executive, the executive owes income tax only at the time of actual receipt of the payments.

Withdrawals: How Much – An alternative to the use of triggering events is to permit withdrawal rights for the executive under the NQDC plan, but impose a substantial burden upon the exercise of such withdrawal rights. Again the Service has approved of the use of such penalties, including "haircut" provisions and suspension from future participation.[18] Thus if the executive exercises his/her withdrawal rights, there is taxation only at the time of exercise, and the executive either forfeits a percentage of his/her total deferred benefits and/or is suspended from future plan participation for some period of time. The Service has approved of haircut penalties as low as 5%, 6% and 10%,[19] and suspension periods of six months to a year.[20]

While the potential for abuse exists for executives to exercise these provisions while the employer is in financial trouble, withdrawn payments are subject to the terms of the Fraudulent Conveyance Act.[21] Thus any payments made by the employer to an insider (*e.g.*, executive) within the previous 12 months of bankruptcy may be rescinded by the bankruptcy courts. **Certainly Congress can question whether such penalties and suspension periods are too generous to the executive and decide to impose more restrictive provisions. Also Congress may decide to extend the reach of the bankruptcy statutes to a longer look-back period.**

Not Yet Withdrawn: Securing the Assets – As the above rules do not protect the executive from the employer's later "change of heart," executives have sought ways of "securing" or informally funding the employer's promise to pay these deferred payments. The first private letter ruling in which the Service affirmed the use of such security involved a rabbi whose congregation desired to establish a trust to fund his deferred compensation.[22] The Service approved of the use of a trust (coined the "rabbi trust"), whereby employer assets could be set aside or segregated for the express purpose of satisfying its obligations under the NQDC plan, securing for the rabbi that the monies would be there when promised. The assets in the rabbi trust had to be available to the employer's creditors in the event of bankruptcy or insolvency; unless so conditioned, the rabbi would have a secured promise to pay from the employer resulting in immediate taxation for the rabbi.[23] For tax purposes, the rabbi trust is an employer grantor trust under IRC §671 whereby income, losses, and deductions flow back to the employer.[24] The use of such a security device also does not result in "funding" for ERISA purposes, thereby subjecting the underlying plan to its participation, vesting, funding and fiduciary rules.[25]

Rabbi trusts are the most common funding vehicle used by employers today to secure the availability of monies when due.[26] There is no requirement as to a minimum level of assets that must be maintained in the rabbi trust. The assets are not provided the same tax benefits as assets under qualified retirement plans (which accumulate tax-free until distribution). Instead the assets under the rabbi trust are taxed to the employer as they are earned at the corporate tax rates (unless invested in tax-exempt vehicles).[27] Benefits are then paid to the executives when due and taxed when actually received under the NQDC plan (unless used for the benefit of the employer's creditors in the event of bankruptcy or insolvency), resulting in a corresponding deduction for the employer. Rabbi trusts have become so popular that the Service has issued model rabbi trust language, which sets forth mandated, alternative and optional provisions.[28] The Service did not provide sample language in its model rabbi trust for the use of haircut provisions. As the Service has announced its intention not to issue any future private letter rulings on trust provisions that deviate from the model language, it is not clear whether the Service is retreating from its prior position regarding the use of haircut clauses.[29]

Employers using rabbi trusts may not necessarily wish to fund the trust at its inception, preferring instead to use such assets for business purposes. To alleviate the executives' concerns, the trust may then *require* the "funding" with assets upon the occurrence of a triggering event (*e.g.*, change of control).[30] Such trusts are commonly known as "springing trusts" as the trust becomes "funded" once the triggering event occurs. The Service has explicitly approved in its model rabbi trust document the use of a "change of control" triggering event for funding purposes.[31] Other triggering events that are commonly used in funding rabbi trusts include the "potential change in control" (*i.e.*, announcement of a take-over bid) or "change of heart" (*i.e.*, employer's refusal to pay benefits under the plan in bad faith or without cause). Because the Service has approved the funding of the rabbi trust as its inception, subsequent funding of the trust triggered by certain events should present no constructive receipt issues for the executive. Some rabbi trusts are expanding the list of triggering events to include such things as the employer's liquidation, decline in its credit-worthiness, or inability to meet its debts when due. **Congress could explicitly provide that the events relating to the employer's financial health are triggering events that will result in constructive receipt for executives.**

There have been a variety of non-cash methods used by employers to provide some security for executives under the rabbi trust prior to the triggering event which would require full funding. Such methods may prove costly and cumbersome, and may raise corporate law and securities issues. These methods include use of a letter of credit;[32] use of employer stock;[33] and use of a warrant to issue employer stock.[34] Corporate-owned life insurance may also be an underlying asset of the NQDC plan; however, discussion of the use of such an asset is beyond the scope of my testimony.

Not Yet Withdrawn: Retrieving the Assets – One potentially serious problem is the establishment of the rabbi trusts offshore (*i.e.*, outside the jurisdiction of the U.S. courts) or their establishment by a foreign employer, in order to keep them from the employer's creditors.[35] This added layer of protection obviously creates more difficulty and cost for the employer's creditors in collecting such assets in the event of bankruptcy or insolvency. The Service has indicated that it will not issue advance rulings on rabbi trusts established by foreign employers or in foreign countries.[36] **If perceived as an abuse of the rabbi trust security device, Congress could clearly require that the assets of a rabbi trust have a trust situs and be located within the jurisdiction of the United States.**

In lieu of using a rabbi trust, executives have relied upon third party guarantors to make the promised payments in the event the employer becomes bankrupt or insolvent. Executives have used surety bonds,[37] letters of credit,[38] indemnity insurance,[39] shadow trusts, agency agreements, escrow arrangements,[40] and grantor trusts known as secular trusts.[41] Use of insurance-type guarantees is generally temporary in nature, as these policies are short in duration and limited in coverage; they may also be available only for larger and financially sound employers. Use of escrows or agency agreements permit the employer to revoke the agreement upon the occurrence of certain triggering events (*e.g.*, change of control) in order to provide greater control for the employer over the direction of the assets. The Service has ruled that such agency-type arrangements do not subject the executive to any immediate tax. Such arrangements generally afford *less* protection to the executive than the traditional rabbi trust. Despite the variety of these third party guarantees, the use of the rabbi trust continues to be the most popular security device.

Not Yet Withdrawn, But Taxed to Employee – At the other end of the spectrum, the employer and the executive may agree to formally fund the NQDC plan by means of a grantor trust known as a "secular trust," which can protect the executive even against the risk of employer bankruptcy or insolvency.[42] An irrevocable trust is established which provides the executive with exclusive rights to receive future benefits. Employer contributions to the trust are deductible when made, as the executive (as owner of the trust) is taxed immediately on such amounts and any interest/earnings as earned.[43] Due to the immediate taxation of interest/earnings to the executive, it may be desirable to use life insurance as a funding asset as its cash accumulation may be tax-sheltered.

The attractiveness of a secular trust is better understood when corporate tax rates exceed individual income tax rates, as the tax saved by the employer's deduction for contributions made to the secular trust exceeds the income tax paid by the executive. If the executive's pay is grossed-up for the additional tax, there is no downside for the executive. So long as the maximum individual income tax rates (ranging from 15% to 38.6%)[44] have exceeded the maximum corporate tax rates (ranging from 15% to 38%)[45], the secular trust has been less appealing from a tax vantage point. The Service has issued favorable rulings regarding secular trusts, but has yet to issue a model secular trust document.[46] While the DOL has ruled on the use of a rabbi trust for NQDC plans, it has yet to rule as to whether the use of a secular trust would cause the underlying NQDC plan to be "funded" for ERISA purposes. **Thus, use of secular trusts may cause some problems under ERISA, but those issues are outside the scope of today's discussion.**

Hybrids – There are a few hybrid funding vehicles that attempt to combine elements of both the rabbi trust and the secular trust. One such vehicle is known as the **rabbicular trust**. Upon its inception, it is a rabbi trust with no resulting tax consequences to the executive. But upon the triggering of certain events, the rabbi trust is terminated and the assets are distributed to individual secular trusts (which are then protected from the employer's general creditors). Obviously at the occurrence of the triggering event, the executive becomes taxable on the amounts distributed from the rabbi trust and contributed to the secular trust. If the triggering event is simply a change in control, there should be no adverse consequence to the executive under the rabbi trust as the IRS' model Rabbi Trust document permits such triggering event to fund the rabbi trust and make it irrevocable. In addition, the normal deferred compensation rules do not constructively tax the executive simply because the executive obtains the right to withdraw monies from the NQDC upon a change of control. However, if the triggering event is tied to the employer's financial health or its bankruptcy or insolvency, the Service is likely to view the executive to be in constructive receipt of the deferrals as he/she is no longer subject to any risk of loss. In addition, the bankruptcy look-back provisions may recapture the assets transferred to the secular trust.

Another vehicle, known as the **vesting trust** or the **non-sectarian trust**, is similar to the secular trust arrangement, but is established on a separate basis. The trust then is taxable as a separate entity. The vesting trust is structured to pay benefits to the executives *only if* certain triggering events occur; if the events do not occur, the monies revert back to the employer and the executive is paid directly by the employer out of its general assets. While the Service has not formally ruled on such an arrangement, it may regard it as a funded arrangement, thereby taxable under the Code.[48]

A vehicle known as a **secured trust**[49] has been described as a trust that protects NQDC plans in the event of an employer's insolvency. This trust is structured so as to provide benefits to the executive *only if* the employer goes bankrupt or has a change of control, and thus is *not* subject to the claims of the employer's creditors. If the executive terminates employment *prior* to these triggering event, his/her benefits are forfeited under the trust and the monies revert back to the employer. The employer is regarded as a contingent beneficiary under the secured trust, as it *may* receive the monies in the event of the executive's termination of employment.

If the employer goes bankrupt before the executive terminates employment, the secured trust pays the benefits to the executive as it is not subject to the claims of the creditors. And if the employer is financially healthy at the time of the executive's termination, it simply pays the executive its deferred compensation out of its general assets and the assets of the secured trust revert back to the employer. The executive is certainly at risk that the employer may have a "change of heart" at the time of termination as he/she will be then relying on the employer's general assets for payment. The argument is made that the executive has no constructive receipt in the secured trust as he/she is subject to a substantial risk of forfeiture (*i.e.*, receiving payment *only if* the employer goes bankrupt or has a change in control).

The final vehicle discussed is known as a **heavenly trust**.[50] This refers to a use of two trusts – a rabbi trust where assets are set aside for NQDC benefits but subject to the claims of creditors and a secured trust that is established solely to pay benefits in the event of the employer's insolvency or bankruptcy and is not subject to the claims of creditors. The argument is made that the rabbi trust results in no constructive receipt to the executive as it is subject to the claims of creditors, and that the secured trust results in no constructive receipt as benefits are subject to a "substantial risk of forfeiture" due to the unlikelihood of the employer going bankrupt or insolvent. The Service is likely to view the combined use of the trusts as resulting in constructive receipt as they eliminate any risk of loss or forfeiture for the executive.

The Service has yet to rule on either a secured trust or a heavenly trust; employers relying on such trust would certainly be advised to seek an opinion letter from counsel. The secured trust used alone (without a tandem rabbi trust) subjects the executive to the risk that the employer could have a "change of heart." The heavenly trust appears to insulate the executive from any risk. **Congress could certainly legislate that the use of such hybrid arrangements will result in constructive receipt for the executive. However, the use of the rabbicular trust is clearly permissible under the IRS model rabbi trust document if the change of control is the triggering event. Thus Congress may wish to limit its changes to triggering events that relate to the employer's financial condition (*e.g.,* bankruptcy or insolvency).**

IV Conclusion

I thank you for the opportunity to discuss this topic with you. While the popular press has sensationalized executive compensation plans, drawing attention to the large fortunes of deferred compensation amassed for and by executives, the fault does not lie with the application of the federal tax code. The federal code taxes the employer *immediately* on such deferrals, deferring the corporate-level deduction until the actual time of payment to the employee, and requires that these deferrals be subject to significant risk of loss/forfeiture in order to avoid immediate taxation for the executive.

In closing, I would like to propose possible solutions to certained perceived problems. If Congress believes that nonqualified deferrals should be subject to even **greater risks of forfeitures**, certainly such restrictions may be added to the Code and regulated by the Service. However, such added restrictions might appear excessive, given that the IRS receives taxes in NQDC plans currently. If Congress' real concern goes to the **magnitude** of the deferred compensation package for an individual executive, the Service already has the power to deny the employer's later deductions at the time of payout, to the extent they are judged unreasonable and excessive.[51]

If Congress' real concern goes to the **timing** of such payments (*e.g.*, in contemplation of bankruptcy), then this important issue is covered not by the tax code but by the bankruptcy statutes.

If Congress believes that **offshore assets** are too far away for creditors' reach, certainly Congress may legislate a retrieval and instruct the Service to issue rulings to that effect.

But if Congress' real motivation is to regulate the dollar limits and type of compensation that may be paid to executives, both in absolute and relative terms, I certainly question whether the tax code is the most expedient vehicle to accomplish such result.[52] Congress' attempts in 1984 to regulate the amount of "excess parachute payments" (*i.e.*, non-performance related payments that become payable to an executive solely upon a change of control) by denying employer's deductions and assessing excise taxes on executives have not been entirely successful.[53] Employers design their parachute agreements to make sense from a business perspective, even if part of the deduction is foregone. And if necessary, executives may be given a tax gross-up allowance by the employer to offset the resulting excise and income tax consequences for the excessive parachute payments.[34] Thus, such arrangements may cost more in terms of taxes, but if they make sense from a business perspective, the practice will not be eliminated.

Finally if Congress decides to legislate in this area, it may consider whether adding *new* layers of complexity at the individual and corporate level to reduce the level of NQDC plans is counter-intuitive at a time when Congress is trying to simplify the tax code.

Footnotes

[1] The author would like to acknowledge the efforts of the JMLS employee benefit graduate students Christopher Condeluci, Joseph Yonadi, and Daniel Zimbler in their fine research and analytical skills in drafting this testimony.

[2] IRC §404(a)(5) (known as the "matching rule" whereby the employer's deduction must match the employee's inclusion of such amounts as taxable income for the same tax year).

[3] IRC §404(a)(1)-(3).

[4] *See Albertson's, Inc. v. Commissioner*, 42 F.3d 537 (9th Cir. 1994), *rev'g* 38 F.3d 1046 (9th Cir. 1993) (see *also* 95 T.C. 415 (1990)) where the Ninth Circuit reversed its earlier decision and agreed with the Tax Court's conclusion that a current deduction for an employer for the interest/earnings component of a nonqualified deferred compensation plan would be contrary to the intent of IRC §404(a)(5). Thus, such interest and earnings would be subject to the matching rule of IRC §404(a)(5).

[5] *See* IRS Regs. § 1.451-2(a) which provide "[i]ncome although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."

[6] *See* IRC §§401(a)(17) and 415 which impose compensation ceilings and maximum benefit/contribution ceilings for qualified defined benefit and defined contribution plans.

[7] *See* IRC §411(a) which sets forth the appropriate vesting schedules that may be used in a qualified plan and IRC §414(s) which provide definitions of "compensation" for qualified plan purposes that do not include nonqualified deferred compensation.

[8] These tax rules are the constructive receipt doctrine (*see supra* note 5); the economic benefit doctrine (*see* GCM 35196 (Jan. 16, 1973); and §83 requirements regarding property transferred to an individual in connection with the performance of services (*see* IRS Regs. §1.83-3(e)).

[9] In 1978, the Service attempted to reverse its prior constructive receipt rules by stating that forfeitures provisions would no longer protect deferrals from constructive receipt. Congress reacted by passing §132 of the Revenue Act of 1978, which provided that the tax treatment of private deferred compensation plans would be determined in accordance with principles set forth in regulations, rulings and caselaw which were in effect February 1, 1978.

[10] *See Veit v. Commissioner* (referred to as *Veit I*), 8 T.C. 809 (1947), acq. 1947-2 C.B.4, where the Tax Court permitted the taxpayer's deferral election even though most of the services had been performed as the amount due was not definitely determinable; *Veit v. Commissioner* (referred to as *Veit II*), 8 T.C. 919 (1949), where the taxpayer's election was permitted to change payment schemes even though the amounts were determinable; and

Martin v. Commissioner, 96 T.C.814 (1991), appeal dism'd (10th Cir. 2/18/92), affirming the taxpayer's change in payment schemes shortly before termination of employment.

[11] The Social Security Amendments of 1983 created a special timing rule for NQDC benefits, subjecting them to taxation at the later of (1) the time of the performance of services or (2) when such benefits are no longer subject to a substantial risk of forfeiture. Thus, for NQDC benefits that are not subject to any substantial risk of forfeiture, benefits are taxable when the services are performed. For many executives, this will result in Medicare Tax of 1.45% on all such amounts (as there is no maximum taxable wage base used on the medical portion of the FICA tax rate). However, if the NQDC benefits are subject to a substantial risk of forfeiture, the FICA payments are delayed until the risk lapses; if the lapse occurs at the executive's retirement, this will subject the entire amount of the NQDC benefits subject to FICA taxes.

[12] *See supra* note 5.

[13] *See* Nonqualified Plans Discussed by IRS Official, RIA Executive Compensation & Taxation Coordinator (Jan., 1996), page 6 (IRS official indicates that the mere existence of certain triggering provisions may cause the executive to have immediate taxation).

[14] *See* Rev. Rul. 60-31, 1960-1 C.B. 174, modified by Rev. Rul. 64-279, 1964-2 C.B.121, and Rev. Rul. 70-435, 1970-2 C.B. 100.

[15] *See* PLR 9508014 (Nov. 22, 1994) ("the Plan provides that benefits will be paid upon ... the voluntary termination of the plan by a corporate successor"); PLR 9204012 (Oct. 23, 1991); PLR 8746052 (Aug. 19, 1987) (amounts were paid after an involuntary termination following a change of control); PLR 8418095 (Jan. 31, 1984) (deferrals become immediately payable upon a change of control).

[16] PLR 9508014 (Nov. 22, 1994) ("the plan automatically terminates if the Company's net worth falls below $10,000,000).

[17] PLR 8435031 (May 24, 1984) ("In the event that the employer is liquidated, pursuant to a transaction whereby a successor corporation assumes the assets and liabilities of the Employer, the entire value of the [deferral] is to be paid to the Employee ... in one lump sum").

[18] *See* Rev. Rul. 55-423, 1955-1 C.B. 41 and Rev. Rul. 80-157, 1980 -1 C.B. 186.

[19] *See, e.g.,* PLR 8557052, 8123097 (March 12, 1981), 8107013 (1981). For further discussion of haircut pr[illegible] see Jennifer Roof, *Haircut plans: A viable means for executive compensation planning?*, Journal of Deferred Compensation (Summer 2000).

[20] *See* Rev. Rul. 55-423, 1955-1 C.B. 41 (which approved a six-month suspension) and Rev. Rul. 77-34, 19[illegible] C.B. 276 (which approved a 12-month suspension).

News From
Carl Levin
U.S. Senator, Michigan
http://levin.senate.gov

STATEMENT OF SENATOR CARL LEVIN
Before The
COMMITEE ON FINANCE
Hearing on
CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION
April 18, 2002

Mr. Chairman, Ranking Member, Members of the Committee, the subject of this hearing and the venue in which it is being held couldn't be more timely and appropriate. On the heels of the Enron collapse, when the country is reeling from the shock of that event and the issues it raises with respect to the operations of corporate America, the Finance Committee should definitely be looking at how our corporations are governed. And executive compensation is surely a major part of the Enron environment.

Ten years ago, in my Subcommittee on Oversight of Government Management of the Governmental Affairs Committee, I decided to look into the matter of runaway CEO pay. Back then, business publications were expressing shock at the disconnect between CEO pay and company performance and the disconnect between CEO pay and what the average worker was making. At that time CEO's were making over 100 times average worker pay. And when we compared CEO pay in the U.S. to that of the leading industrialized companies, it wasn't even close. CEO pay in the U.S. was multiples of what CEO pay was in comparable countries.

Well that was then, and this is now, and here's what's happened since. As you can see from this chart on the growing division between CEO pay and average worker pay, CEO pay in the United States is now 500 times that of the average worker. 500 times. To put that in context a little, J.P. Morgan, not one who has to take a back seat to anyone in supporting rewarding top executives, said when he was one of this country's business leaders, that CEO pay should not exceed 20 times that of average worker pay. 20 times. Now, it's over 500 times.

When we looked into what had happened, starting ten years ago, to create these high rates of compensation, we learned that one major factor was stock options. Designed to be a tool to link pay with performance, they've been awarded in such huge amounts that they've defeated their intent.

Over just the last few months, too many articles to count have described companies where CEO stock option pay has soared despite poor company performance. Global Crossing went bankrupt while its CEO walked away with $730 million in a single year. Oracle Computer stock price dropped 57% in the same year its CEO cashed in stock options for $700 million. Cisco Systems stock price dropped 72% in the same year the company gave its CEO 6 million new options. Other companies repriced options that had lost their value after the stock price dropped, or issued additional options so that executives would benefit even when company stockholders lost.

How does this happen? It happens because stock options are the only form of compensation not required to be reported as an expense on a company's books. We call it stealth compensation, because it doesn't appear to have a cost; it doesn't affect a company's bottom line like every single other form of compensation.

And -- even though they're not required to be charged to earnings as a business expense, they are allowed to be given a tax deduction as a business expense when it comes to a company's tax returns. And because CEO pay and executive compensation is so huge, and the number of stock options sometimes in the millions to one person, the amounts available for a tax deduction to the company are enormous -- in the hundreds of millions of dollars.

After a long battle the Financial Accounting Standards Board which had originally proposed requiring that stock options be charged to earnings and therefore be treated like all other forms of compensation, gave up that fight and instead required companies to report their stock option compensation in a footnote on the financial statement.

Even former Enron President Jeffrey Skilling recognized the significance of stock option compensation when he told the Commerce Committee earlier this year that stock option accounting is an "egregious" manipulation of a company's financial statement, yet he defended Enron's use of it as something everyone does.

Available only to corporate insiders, stock options give employees, most often executives, the right to buy their company's stock at a set price. If the stock price goes up, the individual can exercise the option and buy the stock at the set price, often selling the stock immediately for a profit. Stock options allow company insiders to profit from spikes in the price of company stock, even if the stock price later falls and regular investors lose money.

Enron relied on the stock option double standard to inflate its earnings, avoid payment of corporate taxes, and provide extravagant pay to company insiders even as it spiraled toward bankruptcy.

From 1996 until 2000, Enron told its stockholders that it was rolling in revenues, claiming 5-year income of $1.8 billion, according to an analysis of Enron's public filings by the Center for Tax Justice. Had Enron shown its total stock option compensation as an expense on its books over the five years it took the stock option expense as a tax deduction, its income on its financial statements would have been reduced by almost $600 million. It didn't do that.

Because Enron claimed its $600 million in stock option expenses as a tax deduction, Enron apparently avoided paying any U.S. taxes in 4 out of the last 5 years. This double standard in our tax law inexplicably allows corporations, if they dole out enough stock options to insiders, to take their costs as a business expense on their income tax and escape paying U.S. taxes, while not showing the same expense on their financial statements.

As I said, the sums involved in stock options are huge. Microsoft's 2000 stock option deduction, according to the San Jose Mercury News, for example, totaled $5.54 billion. AOL Time Warner apparently has stock option deductions totaling $11 billion that can be used to shelter corporate income from taxes for the next 20 years.

The corporate executives who benefit from the current system argue that stock option accounting is needed to help companies attract talented executives and show a profit. But the Enron debacle has exposed the self-serving nature of this argument and the damage that the existing stock option double standard does to straight-forward accounting, investor confidence, and tax fairness.

As Warren Buffett, the CEO of Berkshire Hathaway, Inc., wrote: "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses shouldn't go into the calculation of earnings, where in the world should they go? "

The claim is also made that consistent tax and accounting treatment of options would cause companies to stop issuing stock options to average workers. But according to a Bureau of Labor Statistics study in 1999, only about 1.5 percent of all non-executive employees in the United States actually received stock options in their pay. Stock options go primarily to corporate executives, particularly CEOs whose average pay, according to the Business Week study that came out on Monday, now averages $11 million.

Business leaders have denounced stock option abuses and called for reforms. Federal Reserve Chairman Alan Greenspan recently testified that the failure to account for stock options has added three percentage points a year during the late 1990s to reported earnings, and that stock options have encouraged companies to "game the accounting system." Gaming the system to make a company's balance sheet look better than it should in terms of real income is exactly what Enron was all about.

Former Federal Reserve Chairman Paul Volcker has expressed similar sentiments. Warren Buffet, the head of Berkshire-Hathaway, called stock options the "most egregious case of let's-not-face-up-to-reality behavior by executives and accountants." Arthur Levitt, former Chairman of the Securities and Exchange Commission has condemned the "hyperbole" some CEOs use to oppose stock option reform, declaring that honest treatment of stock options will not "be the end of capitalism," nor will it "have a significant negative impact on America's corporations." A leading economist calls stock options "a good idea gone bad." Over 80 percent of the financial analysts surveyed in 2001 by the Association of Investment Management and

Research consider stock options a compensation expense that should be reported as such on company books.

Most important of all, it is in the investor and their representatives who are insisting that stock options be treated on the books in the same way as other forms of compensation. You will hear from two today -- the Council of Institutional Investors and the CEO of TIAA-CREF, a major pension fund. There are others as well.

For example, Bill Mann, the senior editor of Motley Fool, is a strong supporter. Motley Fool is an investment adviser with an online column and radio program heard by 20 million people worldwide each month. It has been warning about stock options since 1998, and Mr. Mann testified about those and other problems related to Enron before the Senate Commerce Committee in December. Mr. Mann observes:

> "There is a reason far beyond the power of America's economy that makes it the destination of choice for so much foreign investment: it is because America's regulatory framework affords outside shareholders a level of protection that is simply unavailable elsewhere."

And in that regard, when it comes to stock options, Mr. Mann notes that current stock option rules hide the "damage" that stock options may have caused to a company's earnings and thereby diminish the protection to investors.

The bill I have introduced with Senators McCain, Fitzgerald, Durbin and Dayton would would put an end to the stock option double standard by requiring companies to be consistent. The bill would require companies to treat stock options on their tax returns the same way they treat them on their financial statements. If a company wants to deduct stock options from its income for tax purposes, then it must do so on its financial statement. If there is no stock option expense on the company books, there can be no expense on the company tax return.

Companies under our bill would have a choice. We don't say no stock options; we do say they have value and treat them that way. Companies can grant options and take them as a tax deduction if they show them as an expense on their books; but, if they choose not to treat stock options as an expense, then they couldn't turn around and tell Uncle Sam the opposite. They would have to tell investors and Uncle Sam the same thing.

That's common sense. And it would put a much needed end to the stock option double standard.

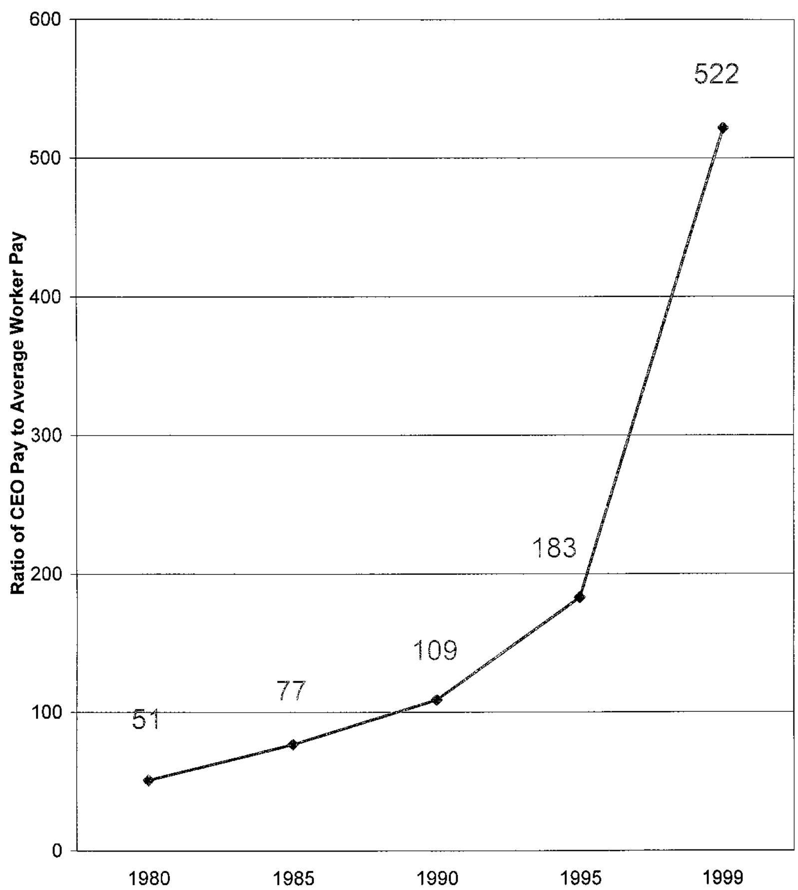
Mr. Chairman, I do not oppose the grant of stock options to company employees. In fact I support their use, when used appropriately and with the true effect of linking pay and performance. But stock options for corporate executives are totally out of control. That's why we can read an article in Business Week this week that reports that the CEO for the Oracle Corporation received $ 706 million in stock option compensation in a year when Oracle stock fell

57% for the year. How can stock options be claimed as pay for performance when a CEO can get $706 million in a year when the company's stock price fell 57%.

Something is wrong in the corporate board rooms of American. And I understand that this hearing will also discuss the role of the Boards of Directors in the skyrocketing growth of CEO pay. I applaud that inquiry. My Permanent Subcommittee on Investigations has subpoenaed and is now interviewing the members of the Board of Directors of the Enron Corporation in preparation for a hearing with some of those board members early next month. We will be asking some of the same questions about Enron's compensation packages that you are here, today, as well as addressing the full panoply of governance issues involving audits, structured financial transactions, insider dealing, and independence.

Again, I thank you for holding today's hearing, and I am happy to answer any questions you may have.

CEO Pay vs. Average Worker Pay



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Top Executive Pay: A Fact Sheet

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Both worker and shareholder interests coalesced in the 1980s to bring the issue of top executive pay to the attention of policymakers. From the worker perspective, efforts at curbing labor costs to improve competitiveness were not shared by corporate heads whose large pay raises also arguably contributed to the growth in wage inequality. From the shareholder viewpoint, it initially was thought that their interests and those of executives would be more closely aligned by relating the latter's raises to company performance through the use of stock-related incentives (e.g., option grants). Although the stock-based, pay-for-performance share of executive compensation has increased in the 1990s, concern in the last few years has arisen about rewarding mediocre performance in a booming stock market, repricing stock options downward in a flat market, and dilution of per share earnings due to the increased issuance of stock options.

It has been argued on behalf of corporate executives that their compensation is commensurate with the job's weighty responsibilities. Sizeable pay packages are needed, according to some compensation consultants, to prevent other firms from luring away successful executives. As the pool of candidates for top executive positions is small that also may be bid up pay levels.

The magnitude of the gap between top executive and worker pay depends, in part, on how executive compensation is measured[1] and on the makeup of the comparison employee group. In 1999, the average base pay (i.e., salary and bonus) of top executives at 362 of the nation's publicly held corporations was 97 times higher — and the average total compensation, 522 times higher — than the average wage of production or nonsupervisory workers at private nonfarm firms. (See **Table 1.**) Although recent decreases in executive salaries and bonuses have caused the ratio of worker to executive

[1] Pay differs if it is reported as a median or average because an average may be raised due to a few large observations. Because there is a direct relationship between firm size and executive compensation (i.e., the larger the firm, the higher the pay), a large sample of firms — which is more likely to include relatively small firms — typically produces a lower estimate of pay than a small sample. Results also vary depending on who is surveyed (e.g., chief executive officers or presidents). Not all surveys include the value of such items as company cars, housing allowances, and club memberships. Surveys may value compensation components differently (e.g., one might include the realized value of stock options in the year they are exercised while another might include the estimated present value of options in the year they are granted).

base pay to decline, the gap between worker pay and executive total compensation has continued to widen as executives have exercised their stock options during the market boom.

Table 1. Average Top Executive and Average Worker Pay

Year	Average Executive Pay		Average Worker Pay	Ratio of Worker Pay to Executive		Percent Change		
	Salary& Bonus (S&B)	Total Compensation (TC)		S&B	TC	Exec. S&B	Exec. TC	Worker Pay
'99	$2,300,000	$12,400,000	$23,753	1:97	1:522	9.5	16.9	3.3
'98	2,100,000	10,600,000	22,994	1:91	1:461	-4.5	35.9	4.1
'97	2,200,000	7,800,000	22,094	1:100	1:353	-4.3	34.9	4.5
'96	2,300,000	5,781,300	21,144	1:109	1:273	39.1	54.3	3.1
'95	1,653,760	3,746,392	20,506	1:81	1:183	18.2	30.0	2.2
'94	1,399,698	2,880,975	20,065	1:70	1:144	9.8	-25.0	3.3
'93	1,274,893	3,841,273	19,429	1:66	1:198	15.4	0.0	2.8
'92	1,104,769	3,842,247	18,908	1:58	1:203	-1.8	55.8	2.7
'91	1,124,770	2,466,292	18,407	1:61	1:134	7.4	26.3	2.5
'90	1,214,090	1,952,806	17,958	1:68	1:109	3.5	5.2	3.3
'89	1,172,533	1,856,697	17,380	1:67	1:107	3.9	-8.3	3.8
'88	1,128,854	2,025,485	16,745	1:67	1:121	16.9	12.5	3.1
'87	965,617	1,800,000	16,250	1:59	1:111	16.4	50.0	2.5
'86	829,887	1,200,000	15,852	1:52	1:76	22.2	0.0	1.9
'85	679,000	1,200,000	15,553	1:44	1:77	4.0	9.1	2.1
'84	653,000	1,100,000	15,229	1:43	1:72	—	76.0	24.6
'80	n.a.	624,996	12,225	—	1:51	—	13.9	96.2
'70	n.a.	548,787	6,231	—	1:88	—	188.3	48.5
'60	n.a.	190,383	4,195	—	1:45	—	—	—

Source: For top executive pay, *Business Week*, various issues; and for worker pay, U.S. Bureau of Labor Statistics' (BLS) establishment survey data. (The *Business Week* survey covers the highest paid executives at 300-400 of the nation's largest publicly held corporations. The BLS data relate to the average weekly earnings of production or nonsupervisory employees on private nonfarm payrolls multiplied by 52 weeks.)

n.a.=not available.

The Washington Post

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TUESDAY, APRIL 9, 2002

Warren Buffett

Stock Options and Common Sense

In 1994 seven slim accounting experts, all intelligent and experienced, unanimously decided that stock options granted to a company's employees were a corporate expense. Six fat CPAs, with similar credentials, unanimously declared these grants were no such thing.

Can it really be that girth, rather than intellect, determines one's accounting principles? Yes indeed, in this case. Obesity—of a monetary sort—almost certainly explained the split vote.

The seven proponents of expense recognition were the members of the Financial Accounting Standards Board, who earned $313,000 annually. Their six adversaries were the managing partners of the (then) Big Six accounting firms, who were raking in multiples of the pay received by their public-interest brethren.

In this duel the Big Six were prodded by corporate CEOs, who fought ferociously to bury the huge and growing cost of options, in order to keep their reported earnings artificially high. And in the pre-Enron world of client-influenced accounting, their auditors were only too happy to lend their support.

The members of Congress decided to adjudicate the fight—who, after all, could be better equipped to evaluate accounting standards?—and then watched as corporate CEOs and their auditors stormed the Capitol. These forces simply blew away the opposition. By an 88-9 vote, U.S. senators made a number of their largest campaign contributors ecstatic by declaring option grants to be expense-free. Darwin could have foreseen this result: It was survival of the fattest.

The argument, it should be emphasized, was not about the use of options. Companies could then, as now, compensate employees in any manner they wished. They could use cash, cars, trips to Hawaii or options as rewards—whatever they felt would be most effective in motivating employees.

But those other forms of compensation had to be recorded as an expense, whereas options—which were, and still are, awarded in wildly disproportionate amounts to the top dogs—simply weren't counted.

The CEOs wanting to keep it that way put forth several arguments. One was that options are hard to value. That is nonsense: I've bought and sold options for 40 years and know their pricing to be highly sophisticated. It's far more problematic to calculate the useful life of machinery, a difficulty that makes the annual depreciation charge merely a guess. No one, however, argues that this imprecision does away with a company's need to record depreciation expense. Likewise, pension expense in corporate America is calculated under wildly varying assumptions, and CPAs regularly allow whatever assumption management picks.

Believe me, CEOs know what their option grants are worth. That's why they fight for them.

It's also argued that options should not lead to a corporate expense being recorded because they do not involve a cash outlay by the company. But neither do grants of restricted stock cause cash to be disbursed—and yet the value of such grants is routinely expensed.

Furthermore, there is a hidden, but very real, cash cost to a company when it issues options. If my company, Berkshire, were to give me a 10-year option on 1,000 shares of A stock at today's market price, it would be compensating me with an asset that has a cash value of at least $20 million—an amount the company could receive today if it sold a similar option in the marketplace. Giving an employee something that alternatively could be sold for hard cash has the same consequences for a company as giving him cash. Incidentally, the day an employee receives an option, he can engage in various market maneuvers that will deliver him immediate cash, even if the market price of his company's stock is below the option's exercise price.

Finally, those against expensing of options advance what I would call the "useful fairy-tale" argument. They say that because the country needs young, innovative companies, many of which are large issuers of options, it would harm the national interest to call option compensation an expense and thereby penalize the "earnings" of these budding enterprises.

Why, then, require cash compensation to be recorded as an expense given that it, too, penalizes earnings of young, promising companies? Indeed, why not have these companies issue options in place of cash for utility and rent payments—and then pretend that these expenses, as well, don't exist? Berkshire will be happy to receive options in lieu of cash for many of the goods and services that we sell corporate America.

At Berkshire we frequently buy companies that awarded options to their employees—and then we do away with the option program. When such a company is negotiating a sale to us, its management rightly expects us to proffer a new performance-based cash program to substitute for the option compensation being lost. These managers—and we—have no trouble calculating the cost to the company of the vanishing program. And in making the substitution, of course, we take on a substantial expense, even though the company that was acquired had never recorded a cost for its option program.

Companies tell their shareholders that options do more to attract, retain and motivate employees than does cash. I believe that's often true. These companies should keep issuing options. But they also should account for this expense just like any other.

A number of senators, led by Carl Levin and John McCain, are now revisiting the subject of properly accounting for options. They believe that American businesses, large or small, can stand honest reporting, and that after Enron-Andersen, no less will do.

I think it is normally unwise for Congress to meddle with accounting standards. In this case, though, Congress fathered an improper standard—and I cheer its return to the crime scene.

This time Congress should listen to the slim accountants. The logic behind their thinking is simple:

1) If options aren't a form of compensation, what are they?

2) If compensation isn't an expense, what is it?

3) And if expenses shouldn't go into the calculation of earnings, where in the world should they go?

The writer is chief executive officer of Berkshire Hathaway Inc., a diversified holding company, and a director of the The Washington Post Co., which has an investment in Berkshire Hathaway.

Sunday, March 31, 2002

The New York Times

Stock Option Excesses

In his Congressional testimony last month, Jeffrey Skilling, Enron's former chief executive, offered a primer on the misuses of stock options. Options, he said, are the most egregious way for companies to pump up their profits artificially. They also netted him a tidy $62.5 million in 2000 and helped Enron pay no income taxes in four of the last five years.

Stock options, in theory, aren't a bad idea. By giving employees the chance to buy a company's stock in the future at today's price, corporations can provide an extra incentive for hard work and can augment compensation. The New York Times Company awards options to its top executives. But like other rational business practices that got out of hand during the boom years of the late 1990's, options have been abused by some companies and are in need of reform.

A good place to start would be for Congress to end the conflict between how the tax laws and the accounting rules treat employee options. Alan Greenspan, the Federal Reserve chairman, has identified that as one of the most pressing post-Enron reforms affecting corporate governance.

That conflict creates a loophole that has allowed companies to treat stock options as essentially free money during the recent dot-com bubble. A company does not have to report grants of stock options as an expense on its profit-and-loss statements, as it does with other forms of compensation, but it can deduct the options as an expense from its tax liability when employees exercise them.

As a result, corporate executives can award themselves oodles of stock options without fear of denting their profit reports. Once the options are exercised, the company can treat the appreciation in the shares' value — the employees' profit — as an expense for tax purposes. At Enron, stock option deductions alone turned what would have been a federal income tax bill of $112 million in 2000 into a $278 million refund. Mr. Greenspan said last week that Federal Reserve Board research found that the average earnings growth rate of the S.& P. 500 companies between 1995 and 2000 would have been reduced by nearly a quarter if the companies had reported their stock options as expenses on financial statements.

A decade ago, the accounting industry proposed a sensible rule to make companies report options as expenses, but it was beaten back by fierce corporate lobbying. Now Senators John McCain and Carl Levin have proposed a bill that would end the double standard, disallowing the tax deduction for any company that fails to report options as an expense.

They are backed in that effort by investors like Warren Buffet and big institutions like pension plans, which are rightly incensed by abusive executive compensation schemes. They are tired of unseemly practices like the repricing of options to ensure that executives still get windfalls if the stock price falls. Making interest-free loans for executives to acquire stock (often forgiven if the bet does not pay off) is another dubious compensation practice.

We have no quarrel with the business lobby's claim that stock options have helped fuel America's entrepreneurship, particularly in Silicon Valley. But in the interest of truthful accounting and greater financial integrity, options should be treated as what they are: a worthy form of compensation that companies must report as an expense.

Congress must end the dot-com-era notion that options equal free money. That would be a first step toward reassuring investors that top executives cannot treat publicly traded companies as Ponzi schemes created for their own enrichment.

A20 THURSDAY, APRIL 18, 2002 R DM VA K

The Washington Post

AN INDEPENDENT NEWSPAPER

Money Talks

ALAN GREENSPAN, perhaps the nation's most revered economist, thinks employee stock options should be counted, like salaries, as a company expense. Warren Buffett, perhaps the nation's foremost investor, has long argued the same line. The Financial Accounting Standards Board, the expert group that writes accounting rules, reached the same conclusion eight years ago. The London-based International Accounting Standards Board recently recommended the same approach. In short, a rather unshort list of experts endorses the common-sense idea that, whether you get paid in cash or company cars or options, the expense should be recorded. Yet today's Senate Finance Committee hearing on the issue is likely to be filled with dissenting voices. There could hardly be a better gauge of money's power in politics.

Why does this matter? Because the current rules—which allow companies to grant executives and other employees millions of dollars in stock options without recording a dime of expenses—make a mockery of corporate accounts. Companies that grant stock options lavishly can be reporting large profits when the truth is that they are taking a large loss. In 2000, for example, Yahoo reported a profit of $71 million, but the real number after adjusting for the cost of employee stock options was a loss of $1.3 billion. Cisco reported $4.6 billion in profits; the real number was a $2.7 billion loss. By reporting make-believe profits, companies may have conned investors into bidding up their stock prices. This is one cause of the Internet bubble, whose bursting helped precipitate last year's economic slowdown.

It is not surprising, therefore, that the expert consensus favors treating options as a corporate expense, which would mean that reported earnings might actually reflect reality. But the dissenters are intimidated by neither experts nor logic. They claim that the value of options is uncertain, so they have no idea what number to put into the accounts. But the price of an option can actually be calculated quite precisely, and managers have no difficulty doing the math for the purposes of tax reporting. The dissenters also claim that options are crucial to the health of young companies. But nobody wants to ban this form of compensation; the goal is merely to have it counted as an expense. Finally, dissenters say that options need not be so counted because granting them involves no cash outlay. But giving employees something that has cash value amounts to giving them cash.

The dissenters include weighty figures in both parties. Sen. Joe Lieberman (D-Conn.) is the chief opponent of options sanity in the Senate, and last week President Bush himself declared that Mr. Greenspan is wrong on this issue. What might be behind this? Many of the corporate executives who give generously to politicians are themselves the beneficiaries of options—often to the tune of millions of dollars. High-tech companies, an important source of campaign cash, are fighting options reform with all they've got. But if these lobbyists are allowed to win the argument, they will undermine a key principle of the financial system. Accounting rules are meant to ensure that investors get good information. Without good information, they cannot know which companies will best use capital, and the whole economy suffers in the long run.

FOOL ON THE HILL

The Danger of Stock Option Grants

Stock options are a great idea run amok, as evidenced by the massive option packages awarded to some high-profile CEOs. Options are given tax treatment so companies have an incentive to depend on them for more of their employee compensation. But options are not free to current investors, as they dilute present and current earnings per share. Bill Mann offers a shorthand he learned from Warren Buffett as a rough instrument to calculate their true cost.

By Bill Mann (TMF Otter)
June 20, 2001

Related Links

The Amazing Stock Option Sleight of Hand (Fortune)

Tech Profits Overstated (National Post)

Berkshire Hathaway Chairman's Letter, 1998

Discussion Boards

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While there have been rumblings about companies' abuses of issuing stock options to employees, there has unfortunately been little popular response from stockholders. This is in part due to lack of a widely accepted means of valuing stock options when considering companies for investment.

Without this common language, agreeing on what constitutes a generous program and what constitutes an abusive one becomes problematic. But because employee stock options are not expensed, casual shareholders may remain blissfully ignorant of the cost to their long-term returns.

Corporate America's attraction to employee stock options came on the heels of the 1973 Employee Retirement Income Security Act, which created tax incentives for companies to set up employee stock option plans. The real kicker, however, came with the special tax treatment of stock options, which allows companies to defer taxation on compensation based upon options. While compensation comprised of cash or stock is taxed at market value, stock options are assumed to have zero value at issuance -- so the employee pays no tax and the company records no expense until the options are exercised.

FOOL ON THE HILL
An Investment Opinion

The Trouble With Options

By Bill Mann (TMF Otter)
October 25, 1999

Many prestigious investment banks in the country have reported rising difficulty in attracting the best and brightest coming out of the nation's top universities. The reason is simple: the attraction to companies offering potentially lucrative stock options. The explosive wealth generated by Internet companies and legends of Silicon Valley secretaries holding millions in stock is a powerful enticement. In a free market economy, people whose efforts create wealth for their companies should rightly derive direct personal benefit.

Options are valuable, a powerful incentive to management and employees since they are encouraged to align their best interests with the shareholders'. But just like every other tool, options have the potential for abuse. Beware, dear Fool, of a company falling over itself to grant huge portions of its total shares to its management and employees. During a time of market appreciation these options will have the effect of diluting your total potential returns; during a market downturn, far more sinister forces can come into play.

Philip Fisher noted many years ago the danger options present to the individual investor:

"Probably most costly of all to the investor is the abuse by insiders of their power of issuing stock options. They can pervert this legitimate method of compensating able management by issuing to themselves amounts of stock far beyond what an unbiased outsider might judge to represent a fair reward for services performed."

Let's explore the risk factors over-exuberant option granting can cause investors. First and most simply, options increase the float of shares outstanding, thereby diluting earnings per share of the stock. A rational options program will, at any one point, reserve no more than 5% of the current outstanding float for options. A look at the current 10-K for **Merrill Lynch** (NYSE: MER), for example, shows that its management and employees have unexercised options equaling 52% of its total float. More than half! And generally accepted accounting practices (GAAP) do not require the company to list the value of these options as an expense.

As Warren Buffett said in the most recent **Berkshire Hathaway** (NYSE: BRK.A) annual report, "If options are not a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where should they go?" Under GAAP rules, options can be granted by companies without being included as a salary expense on the balance sheet. Simply speaking, the company can pay its employees millions of dollars with zero effect on the bottom line.

This means that the management can pay themselves enormous pay packages weighed heavily in options without impacting the bottom line of the company. The cost comes in the form of share dilution, affecting the shareholders by lowering EPS. Companies get to compensate employees in a way that allows them to ignore the cost on their balance sheet. This would seem to be a simple choice for management: pay themselves in cash and count it as a G&A expense, or pay themselves in options and ignore the cost.

The second risk factor comes in the form of repricing, which is truly a "heads I win, tails you lose" proposition. Last September, when the share prices of many companies fell by 25% or more, many options were priced higher than the actual current share price. To combat this, certain companies took the opportunity to reduce the per share cost of their options, a charge which is reflected upon their balance sheet. This would be similar to your getting a rebate at company expense on your stock because its value decreased after you bought it.

This, of course, is absurd. Equity investments are not insured, and erosion of asset value is a risk we each face. Repricing removes the raison d'etre for options in the first place: executive compensation based upon performance. Further, it builds a new wall between shareholders and managers -- even if properly accounted for, repricing is a benefit to the management at direct expense to shareholders. If only we had the same tool to write off losses!

The next and perhaps most sinister risk is dilution of shareholder equity and hidden costs. Let's take **Citigroup** (NYSE: C) for example -- not because their options program is especially bad, because it is not. What is remarkable about Citigroup? Its CEO, Sandy Weill, earned a total of $240 million in options for 1998. This extraordinary amount was not paid for by the company; they don't even have to list it as an expense. Rather, it was paid by the Citigroup shareholders in per share profit dilution. Currently, Citigroup has set aside 166 million option shares, or 7.4% of all outstanding shares. Relatively speaking, this is not high. Fifteen of America's 200 largest companies have set aside more than 25% of their total shares for employee options, and 93 of the same companies have granted their CEOs option packages in excess of $10 million.

Does this mean that the amount of shares is going to increase faster than revenues? One of the major Foolish tenets in evaluating a company is to determine shareholder friendliness by ensuring that the number of total shares does not increase too quickly, as rapid gains in shares issued cause company earnings to be spread across an increased number of shares. Citigroup repurchased $840 million of its own shares last year, undoubtedly a good thing. But factoring in the lucrative package to Mr. Weill means that only $600 million of that money went to actually retiring shares. However, relative to many of the largest companies, Citigroup's options program is fairly benign to shareholders, since the total percentage of equity is low.

There is also the Immutable Law of Unintended Consequences. This law has yet to be tested, since the Golden Age of the Stock Option (the '90s) has thus far only coincided with the greatest market rise in history. With the rapidly rising market, the wealth created through options is thus far paper wealth, as holders of these options have been only too happy to hold on and let them accumulate value. But what happens during a prolonged downturn? Are these option holders going to exit the market en masse in order to lock in their returns?

Corporations' current dependence upon options means that we have the highest percentage of shares distributed in closed market environments (i.e., not at competitive market pricing) in history. We have yet to reach that point, but Wisdom has long since preached for diversification to hedge against downturns. Will a decline become exponentially heightened because employees fear maintaining too much of their net worth in one company? We are fortunate in many ways not to have suffered a long downturn this decade, but there will be a point in the future when the stock markets do not rise. How will the existence of billions of dollars of options shares change how the market reacts?

So watch those options, they're listed in every company's 10-K and 10-Q. Make sure that you take the time to determine the percentage of "live options" versus the total float of the company. If the percentage seems high, the company's management may have their hands in your pocket. Options are a valuable tool to force management to keep their eyes on the performance of the company, but they comprise yet another tool ripe for abuse.

FOOL ON THE HILL

The Stock Option War Rages On

In what would be a reversal of its earlier opposition to placing stock options accounting on company financials, the Council for Institutional Investors has signaled that it may support a proposal by the International Accounting Standards Board to require companies to expense options granted to employees. The U.S.' Financial Accounting Standards Board tried to do the same thing in 1995, but was shouted down by companies claiming it would be too expensive. Not doing so, however, has been awfully expensive for investors.

By Bill Mann (TMF Otter)
November 2, 2001

It was one of those articles that only unrepentant accounting and finance geeks would have found interesting: a brief note from Bloomberg News saying the Council of Institutional Investors is considering support of a proposal by the International Accounting Standards Board (IASB) that provides a framework for stock option accounting. Try to contain your excitement.

The IASB does not have any control over United States accounting practices, which are applied by the Financial Accounting Standards Board (FASB). But IASB is chartered to try to harmonize the accounting standards around the world, and is an influential organization. That a group of institutional investors is considering throwing support behind its proposal is very important.

Many once high-flying companies are currently foundering, but even in situations where executive teams have failed to provide any value to shareholders many executives are receiving massive pay packages in the form of stock options and other grants. In one of the most egregious cases of pay having little to do with management results, **Lucent** (NYSE: LU) provided its ousted CEO and CFO with severance packages that, including stock option grants, exceeded $18 million -- despite the fact that those two individuals presided over one of the largest destructions of capital since the Germans bombed London in World War II.

But Lucent is not alone. As executive compensation has surged, many corporate leaders now negotiate terms of separation when accepting a job. This, however, throws the argument of "stock options aligning management and shareholder interests" out the window. As far as I know, there is no "in case I fail" clause available to outside investors. These are only component parts of a massive rise in management compensation rates, but the most troubling part of this rise is that so much of this compensation comes in the form of stock options.

Stock options became popular in the late 1980s in the U.S. as a way to reward executives for performance. They have become so popular that current executives of the companies in the S&P 500 own more than 13% of all outstanding shares. Granted, some of these were acquired other ways, but a big portion came from stock option grants. In 1999, **Apple Computer** (Nasdaq: AAPL) issued options that, if all were exercised, would have increased its sharecount by 18%.

Companies like this practice because stock options have almost no effect on their stated earnings: Options need not be reported on financials according to U.S. Generally Accepted Accounting Practices (GAAP), so a company can print nearly limitless amounts of options and only disclose it in a footnote. The shareholder may not notice the effect of the dilution, but it is there. Between 1991 and 2000 **Microsoft** (Nasdaq: MSFT), for example, issued 1.6 billion shares in options, also buying 677 million of its own shares on the open market, for a cost of $16.2 billion.

That means any existing shareholder from 1991 to today has endured a more than 18% dilution of his proportionate ownership in Microsoft, and further received no beneficial gain from the $16.2 billion that was used simply to keep the dilution from being worse. Admittedly, a shareowner in Microsoft from 1991 to today has enjoyed a fairly dramatic rise in the value of his investment, but those billions of dollars and that enormous dilution has nevertheless eaten substantially into his potential gains.

If they're not an expense, why're they so expensive?
The problem, as has been identified by the IASB, the Council of Institutional Investors, FASB (which put forth an option expensing methodology that was rejected as a result of heavy lobbying by U.S. corporations), and such influential investors as CalPERS, TIAA-CREF, and even Warren Buffett, is that there is no real accounting treatment of options.

Buffett, the chairman of **Berkshire Hathaway** (NYSE: BRK.A) -- he uses cash bonuses for his company's executives -- famously argued once that options are a form of compensation, compensation costs are expenses, and expenses should go into the calculation of earnings. He's right -- or else all of the "earnings" many companies have racked up over the last decade or so are mere illusions of accounting.

What has been frustrating to proponents of expensing options is that robust methods already exist to calculate their value, most notably the Black-Scholes formula. Granted, these valuations are going to be necessarily esoteric, but this does not stop GAAP in other areas. It is not as if depreciation is an exact science, for example, and many companies operate out of facilities that were reduced to zero value on their balance sheets long ago.

Accounting for option costs is right, and it should have been done long ago. In 1995, FASB's attempt to have option pricing reflected in financial statements was fought vigorously, in particular by Silicon Valley tech companies, which relied upon them heavily for compensation. The reason? Expensing options would have cost them too much.

But it wouldn't have, really. Companies would not have to open up their pocketbooks anymore than they do now. The issue, rather, is that options expensing would have made their earnings numbers look much worse. Fine, but would it not also mean that the financial statements would have reflected reality better? What is it that investors are buying? The true economic return of a company, or a really good story that should not be besmirched by bad stuff, whether or not it really exists?

I applaud the IASB and the Council for Institutional Investors for taking up the charge to get options properly represented in company financials. IASB may be able to place enough pressure to get a change in U.S. (and foreign) GAAP where FASB, acting alone, failed. Investors do not need happy financial statements, but ones that clearly and accurately depict the economic return of companies. Where stock options have an obvious and clear impact on shareholder returns, they need to be disclosed in no uncertain terms.

Fool on!

Bill Mann, TMFOtter on the Fool Discussion Boards

Bill Mann wanted his daughter to dress up as "Tiny Elvis" for Halloween. His wife was not amused. He owns shares in Berkshire Hathaway. The Motley Fool is investors writing for investors.

FEATURES

Stock Options Can Skew Cash Flow

Due to the way that most companies account for stock options, there is no charge to income when options are exercised. However, companies can realize significant cash flow benefits when employees exercise their options. Here, we take a look at cash flow growth of seven companies covered by Motley Fool Research -- Amgen, Cisco, Dell, Gap, Microsoft, Siebel, and Yahoo!

By Phil Weiss (TMF Grape)
December 28, 2000

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Earlier this year, I wrote the first two parts of my ongoing study of stock options (click here for Part 1 and Part 2). The goal of this series is to flesh out how options are accounted for, so that investors can make a more informed decision about how to view them.

As discussed in more detail in Part 1 of this series, the tax benefit related to the exercise of nonqualified stock options is typically not reflected in net income. However, it does result in a deduction on the company's tax return. Here's why: Assume that an employee who has received a non-qualified stock option (NSO) with an exercise price of $20 per share exercises that option when the stock is trading at $50 per share.

When the option is exercised, the employee is taxed on the $30 difference between the $50 exercise price and the $20 grant price. This $30 is wage income for the employee so the company has a $30 compensation deduction for tax purposes. The vast majority of companies don't include this compensation deduction when calculating income under Generally Accepted Accounting Principles (GAAP). The tax deduction is worth $10.50 to the company ($30 times the 35% corporate income tax rate). The effect of the employee stock option exercise does not affect the income statement; instead, it hits the balance sheet as a direct increase in shareholders' equity.

Investors should also note that this adjustment to shareholders' equity might not always match the amount recorded in the cash flow statement. This mismatch happens when a company has a net operating loss for federal income tax purposes and is unable to utilize all of the tax benefit from the option exercise in the current year. This appears to be the case with **Cisco Systems** (Nasdaq: CSCO). In its most recent Statement of Shareholder's Equity, the tax benefit from employee stock option plans was $3,077, while the Statement of Cash Flows showed only $2,495.

The size of the tax benefit also hinges on a company's stock price. There are two reasons for this. First, an increase in the stock price over the grant price results in a greater tax benefit, and second, the price of the stock could influence the number of options being exercised. It will be interesting to observe the impact the struggling stock market has on the size of the cash flow benefit from stock option exercise that companies realize over the next year.

Below is a look at the impact of these stock option exercises on some of the companies covered by Motley Fool Research: Amgen (Nasdaq: AMGN), Cisco, Dell (Nasdaq: DELL), Gap (NYSE: GPS), Microsoft (Nasdaq: MSFT), Siebel Systems (Nasdaq: SEBL), and Yahoo! (Nasdaq: YHOO).

The first table summarizes the growth in reported cash flow from operations year-to-date and for the previous two fiscal years. The second table eliminates the benefit realized from the exercise of stock options and reveals dramatically different results. (Note: Amgen's data for 1998 and 1999 is the same. Prior to this year, Amgen recorded this tax benefit in the financing section of its cash flow statement. As a result, the amount was not part of cash flow from operations and no adjustment was required.) In the past, companies had a choice as to whether to report this item in the operating or financing section of the cash flow statement. However, this is no longer the case, as earlier this year the accounting powers that be determined that this tax benefit should be recorded as part of cash flow from operations. **Microsoft** also previously reported this item in the financing section. It restated its cash flow statement to reflect this change in accounting policy in its 10-K for its year ended this past June.

Reported Growth

	2000 YTD	1999	1998
Amgen	27%	3%	15%
Cisco	20%	42%	51%
Dell	-3%	61%	53%
Gap	-91%	6%	65%
Microsoft	4%	6%	56%
Siebel	566%	37%	301%
Yahoo!	269%	163%	NMF*

Adjusted Growth

	2000 YTD	1999	1998
Amgen	8%	3%	15%
Cisco	-49%	5%	43%
Dell	3%	45%	39%

Gap	-115%	-4%	60%
Microsoft	53%	-16%	46%
Siebel	952%	-62%	317%
Yahoo!	179%	178%	NMF*

*no meaningful figure

Of all the numbers in the above table, the most distressing are Cisco's. Cisco has realized significant cash flow benefits from the exercise of stock options over the last five quarters. If Cisco's stock price continues to suffer, investors should expect the cash flow benefit from option exercise to decline, hurting Cisco's reported cash flow from operations.

I also found Microsoft's first-quarter results quite interesting, as its option-related tax benefit for the first quarter of $435 million was approximately a third of the year-ago result. Microsoft's stock price has certainly trended downward over the last year. The decline in Microsoft's cash flow benefit from this item is an example of the impact the performance of a company's stock price can have on this benefit.

The bottom line here is to be wary of the impact of stock option exercises on cash flow from operations. This benefit is not one that can be counted on with any regularity and is dangerously linked to two things that management has no control over -- stock price and the desire of employees to convert their options into cash.

In the next part of this series, I'll continue this discussion by taking a look some other issues, including the payroll taxes companies pay when options are exercised and, space permitting, the cost of the related shares to the company and its shareholders. If you have any questions, please ask them on our Motley Fool Research Discussion Board.

Related Links:
An Introduction to Stock Options
Stock Options: Income Statement, Balance Sheet, and EPS Impact
Some Thoughts on Stock Options
Optionmania!: Part 1, Part 2, Part 3

But are stock options really worth nothing when they are issued? If so, then why are they such a significant component of compensation? Or, as Warren Buffett said in 1998: "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

Indeed. This is an interesting dichotomy of logic: Companies can calculate depreciation schedules for the value of assets based on their expected useful life, but they are incapable of putting together an appreciation schedule for stock options. I find this argument difficult to accept. And as companies have depended more and more on options for executive compensation, it is a ticking time bomb. Buffett's company, **Berkshire Hathaway** (NYSE: BRK.A), has solved its own stock option dilemma by not offering any. The company awards bonuses to its 112,000 employees in cash, which shows up directly on the balance sheet.

When **Apple Computer** (Nasdaq: AAPL) CEO Steve Jobs can be awarded a single-year options package worth $872 million, it is time investors become more aware of the risk overly generous options programs can present to their portfolios. Far from me to say the CEOs of public companies should *not* be highly compensated, but there is a test of reasonableness Jobs' award fails miserably.

I'm also not opposed to options programs *per se*, but the combination of ignoring the cost of such programs and the potential detriment to outside shareholders demands that we, as minority investors, watch closely. As Sequoia Fund's Jon Brandt pointed out at its most recent shareholder meeting: "If [companies] issue 5% or 6% of their shares annually to employees as options, what they report to shareholders bears no resemblance whatsoever to the outside shareholders' actual share of the earnings."

Back to Warren Buffett, who, for someone who does not use options, has a great deal to say on the subject. When asked by a shareholder how he values stock options when analyzing the fair value for a company, Buffett replied that as a shorthand he uses the following formula to calculate the present value (PV) of its option grants:

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PV = (number of options X exercise price)/3
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By dividing by three, he is taking into account the present value of options that are granted for shares 10 years down the road, a rough average of forfeited options (by those who leave the employ of the company), and other factors. He then takes this number and subtracts it from the company's net income.

I have criticized **Brocade's** (Nasdaq: BRCD) options program in the past, so let's use them as an example. In fiscal year 2000, Brocade issued 30,775,00 employee options at an average strike price of $47.78. For those of you playing the home game, this means that with Brocade's basic share count at 207 million, the company gave its employees more than 14.8% of the company in a single year.

This goes on top of the 14 million that carried over from earlier years. Nearly 45 million shares, 21% of the company, has been awarded to employees.

Let's look at the effect of these options on this year's net earnings. Brocade had net earnings in 2000 of $67 million. But if a rough value of these options were subtracted, we'd find a much rougher situation. If we use Buffett's formula, we find that the cost of the options awarded in 2000 is $490 million, meaning Brocade's options adjusted performance would have been -$423 million dollars.

That's a damn sight worse. Even though Brocade is a strong player in a growing market, I would never, EVER invest money into a company that treats its outside shareholders in such a cavalier fashion. The fact that options are not expensed is, frankly, ludicrous -- and it is enabled by all of us. *Fortune's* Justin Fox wrote a wonderful description of this in the magazine's current issue, where he used the substance abuser's mantra: "Step one to recovery: Admit that options aren't free." Bingo.

Fool community member RoughlyRight recently made the best post I've seen on this subject, including the rough cost of options programs to shareholders of some of the most well-known companies. His post was the catalyst that set me down this line of thinking, and interested investors should check it out.

Options programs are important attractors of talent, particularly in the companies defined by heavy intellectual property. Those who create should be compensated, and well. But where an options program veers into the realm of "kleptocracy" (like Brocade's) or oligarchy (like Apple's) investors need to set their feet down. When a company sets aside more than a percent or two of its "float" -- the total number of outstanding shares on the market -- in options annually, rest assured that the income reported in its financials is far from that which is actually available to shareholders.

Where there is potential for abuse, investors should be particularly watchful. It's like my friend Tom Hopkins said the other day: "Seeing as we're in flood conditions, maybe taking Bog Road isn't such a good idea."

Fool on!

Bill Mann, TMFOtter on the Fool Discussion Boards

Bill Mann assigns great meaning to "perfect moments." This morning he had one: coloring with his daughter, dog at his feet, Cannonball Adderley on the stereo, coffee in hand. At the time of this writing, Bill held shares in Berkshire Hathaway. The Motley Fool is investors writing for investors.

FOOL ON THE HILL
An Investment Opinion

Options Overhang II: The Real Deal

By Louis Corrigan (TMF Seymor)
August 25, 1999

Last week I looked at a *New York Times* article that made much ado about the supposedly dangerous overhang of stock options held by the employees of Nasdaq 100 companies such as **Cisco** (Nasdaq: CSCO). I argued that the potential gloom and doom scenario laid out by columnist Gretchen Morgenson was overblown, in part because the employees who hold these options aren't worried about these tech giants blowing up. So these option-holders aren't glued to the ticker ready to panic on a market sell-off, even a major one. After all, we're talking about 100 of the largest, most vibrant companies on the planet.

Whereas the *Times* engaged in mere spookery, however, *Wall Street Journal* reporter E.S. Browning offered an insightful overview of an options overhang that really should concern investors, especially those who invest in Internet stocks.

As the *Journal's* August 16 article pointed out, 1999 has brought an absolute explosion in the number of new Internet companies tapping the public markets via initial public offerings (IPOs). According to CommScan, 29 Internet-related companies went public during 1997. In 1998, the number jumped 52% to 44. In less than 8 months of 1999, the tally of public Internet wannabes has run to a stunning 166, a 277% increase versus *all* of 1998.

These stats confirm what we already knew: The Internet is creating huge market opportunities, and the capital markets are doing their part to fund new enterprises that are trying to tap into those opportunities. And this frenzy of financing won't be slowed down if the venture capital (VC) firms can help it.

The PriceWaterhouseCoopers Money Tree National Survey, also released August 16, found that VCs invested $7.67 billion in non-public companies during the second quarter of 1999, good for a 104% increase over the amount invested during the year-ago period. The Q2 amount also crushed by 78% the first quarter's then record high investment total of $4.31 billion. Nearly all of this money went into technology companies, with funding of Internet-related businesses quadrupling to $3.8 billion from $947 million a year ago. Indeed, more VC money was channeled into Internet companies last quarter than in all of 1998.

With such an outpouring of new Internet issues and the widening pools of even younger upstarts hankering to go public in the next few years, investors should sit back and consider a handful of relevant facts.

First, the VCs and other early investors funding these upstarts almost certainly want to cash out some of their profits relatively soon. That's just the way VC firms operate. Second, the executives and other employees who accepted fat risks but slim paychecks in exchange for a boatload of options will want to exercise some of those options and sell the related shares in order to purchase a well-deserved new house and, yes, maybe even a sports car.

Yet, these dynamics play out against a backdrop that's not altogether favorable. For starters, not all newly public companies see their stocks shoot to the moon and then go onto Jupiter, despite the plethora of 100% plus opening day advances. Indeed, many solid Internet businesses have hit their highs on the first day of trading and then simply fallen -- and kept on falling. That's what happened to **Marketwatch.com** (Nasdaq: MKTW) and **TheStreet.com** (Nasdaq: TSCM). Insiders at other Internet-related companies may see such massive depreciation of paper profits as a sign that they might want to cash out some or all of their exercisable options as soon as possible.

In other words, new issues are completely different from the Ciscos of the world because these companies generally aren't market leaders with multi-billion-dollar market caps. They're upstarts, and increasingly, upstarts fighting for market share on the fringes of terrain staked out by giants like **America Online** (NYSE: AOL), **Yahoo!** (Nasdaq: YHOO), **eBay** (Nasdaq: EBAY), and **Amazon.com** (Nasdaq: AMZN). To put it bluntly, some of these scrappy companies simply won't be around a few years from now. The IPO money will get spent on marketing pacts that don't pay off, and they'll become also-rans and perhaps bankrupts. Or, at the very least, many of these upstarts will get eaten up by competitors, usually at a stiff discount to their market highs. N2K is proclaimed the leader in CD music sales one year only to merge a year later with **CDNow** (Nasdaq: CDNW), which shortly thereafter decides it must merge with the Columbia House operations of **Time Warner** (NYSE: TWX) and **Sony** (NYSE: SNE).

Employees at these companies simply don't think like Cisco's employees. They can't afford to given that their employer's long-term existence remains very much in doubt. These employees will be a bit more anxious about the market's daily action. In other words, the concerns Morgenson raised in regard to Nasdaq 100 options holders is simply far more applicable to the employees who own options in a newly public Internet company.

In a broader sense, though, such post-offering underperformance is less the exception than the rule when it comes to IPOs. The best academic data indicate that new issues generally underperform comparable companies for up to three years after hitting the market. There are many reasons for this. For starters, these are relatively unseasoned companies that can encounter serious challenges. Moreover, the underwriter's job is to guide the company to go public only when market conditions are most favorable, and to help management sell the company to the investment community. So while underwriters usually price the issue for an expected first day gain of 10% or better (to guarantee the purchasers a profit), the issue price is usually rich compared to what the stock might fetch under less favorable market conditions.

In part, though, a simple supply and demand dynamic is at work. With very few shares initially sold to the public relative to the total number outstanding, strong investor demand for an IPO typically outstrips supply and pushes the price to stunning if perhaps only temporary heights. In this sense, the market for new issues is to some extent a "false" one in that the scarcity of tradable shares in the float is affecting the market's pricing of the business.

This is why the overhang of employee stock options can be so important for newly public companies: The new shares hitting the market change the supply/demand dynamic.

As Browning's *Journal* article pointed out quite nicely, company insiders typically agree to a "lockup period," or a period of generally 180 days after the IPO (but sometimes longer or shorter) during which they agree not to sell any shares, whether owned outright or via exercisable options. Information about the lockup period is usually detailed in the prospectus. This roughly six-month period should allow the stock to find its natural investors so that when and if insiders decide to cash out, the market can absorb the increased supply. Yet, this becomes increasingly less likely as lower quality companies rush to take advantage of the favorable market for Internet issues. And every wave of "hot" stocks ultimately ends with a spate of second-rate "me too" companies going public.

Investors in a hot sector like the Internet must understand, then, what the end of the lockup period might mean for the stocks they own, particularly during a period when the Internet euphoria wanes. Indeed, short-sellers often enter positions just prior to a lockup's end on the expectation that insider sales will hit the market in a rush and pummel the stock. As a result, this potential overhang of employee and VC shares can alone push a stock down even before a lockup ends since short-sellers are, in effect, providing an added supply of shares even before insiders do. In this way, the end of a lockup can create the very flavor of panic that may cause anxious insiders to cash out now before the stock falls any further.

And it need not be merely insider shares coming out of lockup. As Browning's article indicated, shares of **Healtheon** (Nasdaq: HLTH) dipped 19% on August 10 because shares used to acquire another company last year finally became freely tradable. Again, the overhang issue is basically one of new supply meeting fixed demand.

As I've noted before, this supply and demand dynamic also plays out on a broader scale. It's simply not coincidence that Internet stocks fell into a funk after April, as more and more new Internet issues hit the market. In light of the massive VC funding of upstarts that will be looking to come public in the next few years, this suggests that the entire Internet sector should remain quite volatile. And in individual cases, the options overhang could lead to an avalanche that you want to avoid.

Correction: Having slammed Gretchen Morgenson last week, now I must slam myself. In accounting for Cisco's outstanding stock options as of July 25, 1998, I adjusted for the recent 2-for-1 stock split (which Gretchen missed) but failed to account for the 3-for-2 split that occurred in September 1998. Adjusting for both splits, Cisco would have had 646.96 million options outstanding, options that could be exercised at an average price of $8.51. Of these options, 233.1 million were then exercisable at an average price of $4.85.

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Testimony of Robert C. Pozen
Hearing on Corporate Governance and Executive Compensation
Before the Senate Finance Committee (April 18, 2002)

I am currently a lecturer at Harvard University, and formerly served as Vice Chairman of Fidelity Investments. But these are my personal views, and do not represent the views of either Harvard or Fidelity.

Thank you for this opportunity to address the general subject of corporate governance. Since this is a broad subject and your Committee will hear other panels on various aspects of corporate governance, I will focus my remarks on practical suggestions in four key areas:

1) Increasing the effectiveness of the audit committee;
2) Requiring shareholder approval of all stock option plans;
3) Enhancing accounting disclosures to buy-side analysts; and
4) Reducing conflicts of interests for sell-side analysts.

1. Increasing the Effectiveness of the Audit Committee

The typical audit committee of a large corporation is hard pressed to understand and monitor the auditing of the company's financial statements. These are detailed documents involving complex transactions and often foreign operations. Moreover, most auditors view themselves as working primarily for the company's executives rather than for the members of the audit committee. Indeed, many members of the audit committee were probably not directors at the time the auditors were first appointed by the company.

Nor would a self-regulatory organization (SRO) for auditing, patterned after the NASD, have much chance of effectively policing the audit process. The NASD is successful because it concentrates on one line of business in one country – e.g., the U.S. broker-dealer subsidiary of Citigroup. But an inspector for an auditing SRO would have little chance of understanding the complex auditing issues and many transactions of large global companies. It would be particularly difficult for such an inspector to find entities that were omitted from the company's financial statements like off-balance sheet partnerships.

By contrast, mandatory rotation of auditors for public companies would create powerful incentives to adhere to both the letter and spirit of the auditing rules. Every five to seven years, the independent audit committee would choose a new auditor based on a public request for proposals with detailed terms and conditions. The incoming firm would have the time, resources and liability risk to comprehend the critical issues in prior audits. More importantly, the current auditor would know that the incoming firm would subsequently scrutinize its auditing decisions.

Mandatory rotation of auditors would have two other salutary effects. First, the auditors would be more accountable to the audit committee than company management because committee members would interview firms and set the terms of the engagement. Second, the rotation process would provide incentives to create new auditing firms – which we desperately need – because new firms would have many opportunities each year to bid for new audit assignments.

Mandatory rotation could increase modestly the costs of audits. However, these incremental costs could be minimized by a competitive bidding process, together with a requirement that the outgoing firm transfer all of its work papers to the incoming firm. Nevertheless, if higher audit fees became a substantial problem for smaller public companies, the SEC should be given the authority to exempt them from mandatory rotation of auditors.

2. Requiring Shareholder Approval of All Stock Option Plans

Whether stock option plans are good or bad for Corporate America depends heavily on the design of such plans. For example, a well-designed plan should impose a minimum holding period before stock options are exercised, and should link the exercise price to above-average performance of the company's stock. To assure that stock option plans do align the interests of the company's executives with the interests of its shareholders, Congress should require that all stock options plans be approved in advance by shareholders of public companies.

Historically, shareholder approval of most stock option plans was built into the federal securities laws, rather than the federal tax laws (with the exception of performance options). However, several years ago, the SEC simplified its exemption for the exercise of stock options from the prohibitions against short-swing trading in Section 16 of the Securities Exchange Act (requiring company executives to disgorge any profits from purchasing and selling company stock within six months). In the process, the SEC inadvertently eliminated the long-standing condition that shareholders approve any stock option plan qualifying for this much utilized exemption.

Since then, shareholder approval of stock option plans has been mandated mainly in the circumstances set by the listing standards for companies listed for trading on the New York Stock Exchange (NYSE). For example, the NYSE does not require shareholder approval of a stock option plan if 50% or more of its shares are to be awarded to employees other than senior executives and directors. During the last few weeks, however, the NYSE has announced its intention to propose a broader requirement for shareholder approval of any stock option plan where options may be awarded to any senior executive.

In my view, it is unfair to ask the NYSE to undermine its competitive position as a trading market by adopting stricter rules than NASDAQ on shareholder approval of stock option plans. It is also unlikely that NASDAQ and the regional exchanges will voluntarily adopt the same rules on stock option plans as the NYSE, given the competition among these markets. More realistically, the SEC should effectively require all publicly held companies to obtain shareholder approval of all stock option plans -- by reinstating this requirement as a condition to its exemptive rules under Section 16 for the exercise of stock options.

In addition, the SEC's exemptive rules should provide shareholders with the opportunity to vote on fundamental changes to an existing stock option plan. Many stock option plans allow the company's directors to change fundamental elements of a plan after it has been approved by its shareholders. Although directors need some flexibility in implementing stock option plans, they should not unilaterally change fundamental elements of plan design that were probably important in winning shareholder approval of the plan. Such fundamental elements would include, for example, a restriction on decreasing the exercise price of fixed price options if the company's stock price drops. If there are reasonable justifications for such fundamental changes, they should be put before shareholders to ensure that the design of the stock option plan is still appropriate.

3. Enhancing the Accounting Disclosures to Buy-Side Analysts

Buy-side analysts generate proprietary research on securities for the benefit of the mutual funds and pension funds that employ these analysts. Therefore, buy-side analysts have every incentive to figure out whether a stock is over-valued and, if so, to recommend that the mutual fund or pension fund sell the stock. Unfortunately, the efforts of buy-side analysts are hampered by the quality of accounting disclosures by U.S. companies and the uncertainties raised by SEC Regulation FD (Fair Disclosure).

The SEC has announced that it will propose more extensive disclosure of significant accounting policies in the Management, Discussion and Analysis (MD&A) section of a company's annual report. From the analyst's perspective, the most useful disclosures would show the differential impact of management decisions about key accounting issues reflected in the company's financial statements. These decisions sometimes involve judgment calls between two alternative accounting methods – both of which may be acceptable. For example, analysts would like to see the impact on a company's balance sheet of omitting special purpose entities established by the company, and the impact on the company's income statement of applying management's criteria for recognizing revenue from product sales.

In addition, if a company chooses to publish pro forma earnings, it should at the same time publish a reconciliation of these pro forma earnings with its financial statements under GAAP. Companies can sometimes be quite selective in calculating pro forma earnings – e.g., omitting losses generated from special transactions, while including gains from one-time asset sales. If companies are permitted to publish pro forma earnings, they should be required simultaneously to promulgate a side-by-side comparison explaining precisely which items are being treated differently from GAAP in calculating their pro forma earnings.

More generally, the SEC's Regulation FD is serving as a barrier to intensive analysis of complex accounting issues in company financial statements. Regulation FD has a laudable objective – to prevent senior company executives from disseminating market-moving information selectively to certain investors or friends. But Regulation FD is too vague; its prohibitions are couched in terms of "material" information without a definition of this term. As a result, some senior executives make analyst presentations that are heavily scripted by company lawyers, and refuse to answer legitimate accounting questions posed by analysts in follow-up calls.

The SEC could resolve this dilemma by announcing that, for purposes of Regulation FD, "material" information would include only information that the average retail investor would consider important to a company's stock price – for instance, changes in earnings estimates, announcements of acquisitions or retirement of senior executives. By contrast, "material" information should exclude answers to questions on technical accounting issues that would be important only to an analyst who had become an expert on the company's financial statements. By announcing such an exclusion to Regulation

FD, the SEC would be encouraging analysts to become such accounting experts that they can build a "mosaic" of information on company financial statements – without allowing company executives to selectively disclose information that all investors would consider to be important.

4. Reducing the Conflicts of Interest for Sell-Side Analysts

Since 1995, the mutual fund industry has lived with a tough Code of Ethics on potential conflicts of interest. The Code's standard provisions require not only reporting of all personal trades but also pre-approval of most personal trades and effective bans on certain types of transactions by investment analysts and portfolio managers. Until recently, this type of strict Code has not been regularly applied to analysts in Wall Street brokerage firms (sell-side analysts). But now the NASD has proposed a set of rules that will take important steps toward constraining the conflicts of interest faced by some sell-side analysts.

First, sell-side analysts will be required to disclose their personal ownership positions in the securities recommended by them to investors. Sell-side analysts will not be allowed to trade in such a security for a period of 30 days before and 5 days after the release of a research report or the change in a research rating. A sell-side analyst will also not be allowed to trade in his or her personal account against his or her public recommendation on a security.

Second, any research report will be required to disclose any business relationship between the broker-dealer issuing the report and the company covered by the report. For example, the research report would have to disclose that the broker-dealer recommending a security was also the underwriter of the security in the IPO. More broadly, the research report must disclose the percentage of buy, hold and sell recommendations issued by the broker-dealer over the past year. This should be informative to investors, since the portion of sell recommendations issued by most Wall Street firms has averaged below 5%.

Third, the NASD proposals would take research analysts outside the supervision and control of the underwriting department. In addition, the NASD would not allow the sell-side analyst to be paid directly on the basis of revenues from underwriting a specific stock. However, the NASD proposals would allow the compensation of the sell-side analyst to include as a significant factor the firm's underwriting revenues, as long as that compensation factor is disclosed in their research reports.

* * *

Thank you again for this opportunity to testify before the Senate Finance Committee on this critical subject of corporate governance. I would be pleased to respond to any questions or comments you might have on my testimony.

Testimony of Sarah Teslik
Executive Director
Council of Institutional Investors
Senate Finance Committee
18 April 2002

There is more corporate fraud, accounting fraud, and Wall Street fraud than there used to be.

Why? People are not more evil than they used to be. Human nature doesn't change.

There is more fraud because people have *correctly* figured out that *it pays.* Corporate, accounting and financial-services fraud have huge upsides and few downsides.

Why? Because our investor-protecting laws and regulations have been worn down by years of special-interest lobbying. Because decades of loophole finding have paid off better than a lottery. And because *companies* are punished rather than the *people* who commit fraud. That does not deter, it punishes victims and the innocent and lets wrongdoers profit.

The point is this. People will behave badly if they are rewarded for it and risk little. That is the current state of our investor-protection laws. Enron, Global Crossing and others happen because *we let them.* Our safety nets—outside auditors, boards of directors, rating agencies, analysts, the stock exchanges, the SEC and prosecutors—are all failing us at one level or another.

The most important safety net, however, is investors themselves. People will take care of their property unless laws prevent them. We shareholders want to stop those who fleece us by fraud. But we can't. The rules that govern us prevent us.

I have provided examples of these laws in my written remarks. They make for lively reading. But what I want to focus on here is **executive compensation. It is a critical contributor to corporate, accounting and financial-services fraud.** And it is in your jurisdiction.

First, executive compensation is an excellent diagnostic tool. When we see executives paid way too much, or paid more to leave than to work, or paid for failure, or paid for fraud, we know something is wrong. That may seem obvious, but it is important. Most people tell you our markets don't need fixing. But rising executive compensation abuse tells us they do. The reasons are summarized in my written remarks.

Executive compensation is also *the* critical enabler for corporate fraudsters. And stock options are fraudsters' best safe-cracking tools. Without stock options, fraudsters could not turn companies into Ponzi schemes. They could not suck out enough money before the company collapsed to be worth it. Stock options can be printed up as easily as the government mint prints money, so they can be abused more easily than cash, which a company has to have before an executive can take it. Stock options are not bad; they can be good; but they are like a dangerous drug that can cure or become addictive and harmful.

So if you want to crack down on fraud you need to do a few things about executive compensation. First, you need to make sure all CEO and board compensation is disclosed, clearly and immediately. Executives should not be able to dump stock today and tell us tomorrow—or next year. And we shouldn't have to be CFAs to figure out what the packages are worth. The SEC has proposed a few disclosure improvements but I encourage you to watch these efforts to make sure the result in the needed reforms.

Second, shareholders must have the right to vote on all stock option plans. Executives should not be able to print up corporate money to pay themselves without shareholders, who foot the bill, approving. Compensation committees of independent directors are simply *not* enough.

Third, you need to charge options to earnings, even though they are a slightly awkward fit. Options have value, they transfer that value directly from shareholders to the option holders, bypassing the company. Options are a cost of production. They substitute for cash the company might otherwise pay. A charge reflects that substitution. And a charge is an important check on the rampant abuse of options and an accurate reflection of what is left over for shareholders.

The arguments I hear against charging options are the closest thing to humor in the accounting world. **Options don't have value?** Right. Then why are CEOs lobbying you like desperate cocaine addicts fearing withdrawal? **Options value can't be estimated?** An executive who can't work with estimates as concrete as stock option estimates should be in another job. And they sure seem to be able to estimate them for tax purposes. Executives routinely estimate pension and depreciation numbers. Heck, accounting is full of estimates. **Executives won't work without options?** Then those are executives with bad attitudes we'd be lucky to lose—funny that entrepreneurs work the world over without options—they even work at Boeing, which charges its options. **Options charging would cause market collapse?** Pfft. We're talking about an accounting treatment here, not a change in the real world.

There are many ways to tie executives' interests to the long-term success of companies. Options are one way, though not an essential way—boards could do it the old fashioned way and perform a proper annual review, taking stock price and everything else into account, and pay cash. A real evaluation by human beings can assess variables that no formula can capture.

So, do not be taken in by the hype. The difficulty is not in the issue itself but in the pressure you are getting. I do understand that that pressure is tremendous—so I understand that it will take remarkable courage for any of you to support this change. I keep thinking that if we could harness the pressure executives are applying to you *not* to charge options to earnings and direct it, say, at finding Osama Bin Laden, he'd be sitting here today. I wish the same energy would be directed at employees' and shareholders' interests.

Those of you supporting Senators Levin and McCain deserve our respect. You are profiles in courage, and I thank you. You are clearly in good company—Warren Buffett, Alan Greenspan, TIAA-CREF and the Council's many members back you. You seem to understand what others are missing–the fact that we've had a good run of it the past 200 years doesn't guarantee our future. Only you can do that. If we coast, we slow down. We can't do it without clean markets and we won't have clean markets without leaders with courage.

COMMUNICATIONS

Statement

Multiple Employer Welfare Benefits for Working Americans

Submitted by:

Niche Plan Sponsors, Inc.
Newport Beach, CA

Committee On Finance
US Senate

April 18, 2002

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Chairman Baucus, Ranking Member Grassley, and Members of the Committee, thank you for this opportunity to describe the benefits working Americans receive from welfare benefit trusts set up under Internal Revenue Code (IRC) Section 419A(f)(6). We urge you to take the necessary steps required to assure that these valuable benefits remain available to employees of America's small businesses.

First, an introduction: Niche Plan Sponsors, Inc. is itself a small business. We have three owners, with seven full-time employees and two part-time employees. We sponsor three 419A(f)(6) trusts, with over 452 participating employers. Our trusts provide life insurance and severance benefits to *all* of the participating employers' employees, including the owner-employees.

The Purpose of 419A(f)(6) Trusts: Provision of Welfare Benefits

The ability to participate in a multiple employer welfare benefit plan allows all employers—especially small employers—to offer a benefits package that enables them to attract and retain a quality workforce. In addition to the traditional life and health insurance type benefits, the benefits package frequently includes severance benefits. These severance benefits give employees a measure of confidence and security in making a decision to work for a small company that is more vulnerable to dissolution, acquisition, or outright failure as a result of market swings, economic downturns, under-capitalization, cash flow shortages, and other known plights of small business.

Both the amount and the timing of severance benefits are limited by law—benefits can be paid only when severance occurs unexpectedly, and they are limited in amount by a Department of Labor regulation ,that specifies that a severance benefit may not exceed twice the amount of the worker's annual compensation in the year prior to the severance event..

Welfare benefits provided pursuant to Section 419A(f)(6) are bona fide benefits to the employees whose employers adopt such plans, and are necessary to the ongoing success and prosperity of such businesses. Continuing to allow a tax incentive to provide these benefits is in the best interest of the business community, and the workers, who in most cases would not otherwise be covered by such benefits.

This truth is well illustrated by the current crisis engendered by the collapse of the Enron Corporation. Thousands of Enron rank-and-file workers did not receive their promised (but unfunded) severance benefits when they were laid off after Enron filed for bankruptcy late last year. Their claims to those severance benefits are just some of many claims among the creditors of the bankrupt Enron Corp. If these workers receive any benefits at all, it will be mere pennies on the dollar, and months, if not years, after being laid off.

Had Enron participated in a 419A(f)(6) multiple employer welfare benefit plan, monies to pay the severance benefits would have been available to those laid-off workers, because the money would have been held in an independent third-party trust, outside the reach of Enron and its creditors.

Although under current law and current business conditions, it is unlikely that a corporation as large as Enron would choose to participate in a 419A(f)(6) plan, it remains indisputable that had Enron had a 419A(f)(6) plan, Enron's workers would not have lost severance benefits at the very time they needed them most.

Even though Enron type workers might be less likely to benefit from an independently administered, funded welfare plan, workers at small companies—who are more likely to be at risk for bankruptcy during rough economic conditions—do benefit from the protections afforded by a 419A(f)(6) plan. And if the necessary modifications to IRC Section 419A(f)(6) are made, it is at least possible that larger companies would find these plans an affordable way to be sure their workers are protected should business downsizing or outright failure occur.

Currently, the welfare benefits typically provided by a multiple employer plan include death benefits and severance benefits. These are the benefits offered by Niche Marketing Inc.'s trusts. Health insurance and disability income insurance are also allowable benefits that are provided by some multiple employer welfare benefit plans. Some plans also provide long-term care and/or post-retirement medical benefits.

Most small businesses that provide welfare benefits provide them in addition to retirement plans, such as a 401(k) or a pension/profit-sharing plan. Severance benefits are not provided as an alternative to pension plans. In fact, severance benefits are forfeited to the multiple employer trust (not the remaining employees of the employer group) at the retirement of the employee.

A software company in California is a fair example of how severance benefits have provided meaningful benefits to its employees and allowed the business to recruit top-level employees in their field. Technology is a highly competitive field, with fluctuating ups and downs for smaller firms. However, the ability of these firms to recruit and retain skilled employees is crucial to the firms' success.

The California company we're describing here employed 12 people. Their adopted welfare benefit plan levels included a death benefit of ten times compensation and a severance benefit of 10% of compensation per year of service. Following a financial setback, a much larger firm purchased the business in March 1999. The successor firm did not employ the employees, except for the owner-employees. But the employees of the old, small firm received severance benefits—taxed as ordinary income—from the welfare benefit plan, giving them the financial cushion they needed while they found new employment.

If the employer had not been allowed to contribute the cost of the current liability for the stated benefits, then there would have been no money available to provide severance benefits at the time the business was sold. These workers would then have had to deplete their savings, if any, or try to live on unemployment compensation.

In other words, small businesses typically do not have the same ability to "pay as you go" as do larger firms. When properly used, these plans do not offer an unfair advantage to small business—large businesses are also eligible to participate in multiple employer welfare benefit plans. In fact, they instead help small businesses compete with bigger firms for a quality work force.

In short, participation in a 419A(f)(6) trust levels the playing field. It helps minimize a competitive advantage a bigger employer would otherwise enjoy in putting together a compensation package. It puts small employers on a more equal footing as they compete with larger, more established employers for quality workers.

Here's how it works. IRC Section 419A(f)(6) authorizes a tax deduction for contributions to welfare benefit plans within a framework of defined rules. Generally, 10 or more employers must band together to provide welfare benefits; no one participating employer can normally contribute more than 10% of the total plan contributions; there can be no experience rating by employer—i.e., all of a trust's assets at all times must be available to pay benefits to any employee of any participating employer; and there can be no retirement or other deferred compensation type benefits provided through the plan. Assets are independently trusteed and administered, and can never revert to the employer.

The rules seem clear to many 419A(f)(6) plan sponsors, administrators and participants. However, in recent years the ambiguity of the rules has resulted in some advisors recommending strategies that make aggressive use of the 419A(f)(6) rules. Many experts, both in and out of government, believe that a market has arisen for 419A(f)(6) plans that is primarily driven by a desire to shelter income from tax, rather than to provide benefits to employees. Consequently, there is concern about whether the rules need to be tightened to be sure they work as Congress intended—to provide a way to allow 10 or more employers banding together to offer real benefits to real workers.

Initial Proposal to Clarify, Tighten Falls Short

The first salvo in the debate on whether or how to clarify the rules occurred three years ago in then President Clinton's FY 2000 budget submission. That proposal would have limited the 419A(f)(6) deduction to contributions made to trusts that offered only group term life, health and disability income insurance.

This proposal is fatally flawed in that it would eliminate important welfare benefits—including severance benefits. Further, in disallowing the use of permanent life insurance in a trust, it would impose the very cash flow hardship that IRC Section 419A(f)(6) seeks to mitigate—ability to provide protection for employees. At the same time, the proposal, while making the trust benefits more expensive and less useful, would not adequately address the problems that are causing concern among policymakers. "Gaming" that could allow IRC 419A(f)(6) to be used to create a tax shelter could have continued, even had the Clinton proposal been enacted.

The proposal was defeated in a variety of contexts in 2000 and in 2001, but the underlying concerns that prompted the proposal in the first instance were not addressed. As a result, a cloud remains hovering over the 419A(f)(6) marketplace. Employers are uncertain about whether they can continue to participate in multiple employer welfare benefit trusts; and trust sponsors, administrators and participants cannot rely on the continued viability of this important employee benefits tool.

As a result, the usefulness of this tool as a way to attract and retain quality workers is being eroded. The existence of businesses like ours that focus on the operation of these multiple employer welfare benefits trusts, and that help businesses take care of their workforce independent of government sponsored programs is threatened.

Clarification Is Urgently Needed

The uncertainty surrounding the continued existence of multiple employer welfare benefit trusts makes the need for clear rules, as soon as possible, urgent. The rules must assure that these benefit plans operate as intended—that 419A(f)(6) trusts cannot be used as a way to fund deferred compensation on a tax-favorable basis, or as a way to circumvent pension contribution limitations. But clarifying rules, which need to be tight and clear, must also allow continued funding and payment of trust benefits.

Proposed Modifications

To achieve clear, appropriate rules, we respectfully offer a proposal that would eliminate the abuses that cause concern among policymakers and industry representatives alike, but at the same time allow continued availability of multiple employer welfare benefit trusts.

Experience Rating: Our proposal would clearly restate the current law rule that prevents "experience rating" by employer. This means that no participating employer would realize the results of its own experience with respect to benefits, claims paid or forfeited, or segregated asset performance or variance from actuarial assumptions.

This is crucial to the appropriate use of permanent life insurance. It is important to emphasize that we believe that current law prevents use of experience rating by employer, whether overt or covert. But it is apparent that some in the marketplace do not read current law rules as restrictively as we do, and so it is appropriate to restate, with complete clarity, the rule that disallows experience rating by employer.

Discrimination Rules: Our proposal also sets out rules that will assure that all of a participating employer's workers will benefit under the plan. Generally, the proposal follows the IRC Section 410 rules as to eligibility—an employer's plan must cover all workers who are at least age 21, who have one year of service, and who work at least 1,000 hours per year. Further, our proposal would require an employer to use the same formula for benefits for rank-and-file workers as is used for key workers and owners.

Thus, if the owner gets two times salary in death benefit and severance, the workers must also get two times salary in death benefit and severance.

Deduction Limits: We propose limitations on both the level of benefit and on the allowable deduction for the annual funding of accrued benefits. In short, we urge Congress to enact a rule that would limit any year's deduction to the actual cost of the benefit being provided in that year.

Effective Date: Finally, the proposal includes a fair effective date rule—one that gives participating employers and plans time in which to make the changes that would be required by this proposal in order to bring plans into compliance with the new, clarifying rules.

In short, our proposal suggests rules that would: 1) result in multiple employer welfare benefit plans that cover ***all*** a participating employer's workers; 2) appropriately limit the annual deduction available to help fund the benefits; and 3) assure that the plan works equally and as a whole for the benefit of all the workers of the participating employers.

We have tried to design a proposal that meets tax and social policy goals and that works for the entire, diverse Section 419A(f)(6) marketplace. Our own trusts will also need to make significant modifications to comply with these rules. It is likely that all multiple employer welfare benefit trusts currently in existence will face the same need to amend plan rules in order to comply.

We believe this proposal will eliminate the ability to make aggressive and inappropriate use of IRC Section 419A(f)(6), and will allow continued availability of this important tool for designing practical and attractive employee compensation and employment packages. However, the mind set of professionals whose purpose is to provide benefits may not parallel the mind set of people who are trying to maximize tax advantages for owner-employees. We recognize that, although we have tried to be complete and accurate, we may have missed some ways manipulation can occur. We are eager to work with the government's tax experts to be sure our proposal, which perpetuates an important tax incentive for small businesses desiring to protect their workers, achieves all appropriate rule-tightening.

The Details of the Proposal

Details of our proposal are embodied in currently-pending legislation, HR 2370. We remain willing and eager to work with you and your staffs to be sure HR 2370 works as intended. HR 2370 describes funding requirements, antidiscrimination rules, and appropriate limitations on the annual deduction. It delineates the types of benefits that should be available in a multiple employer welfare benefit plan. Finally and very importantly, it offers an effective date rule that protects employers—whose intention was to provide benefits to their workers, not tax shelters for owners and key workers—who have already entered into a Section 419A(f)(6) trust, but requires the trust to make the changes required to come into compliance with the new rules. Failure to make the necessary changes will result in tax liability for those who fail to comply. A chart attached to this testimony outlines the elements of HR 2370.

Summary: Multiple Employer Welfare Benefit Trusts Allow Employer To Offer Well-Designed Employee Compensation Packages, But Current Law 419A(f)(6) Rules Require Clarification

It is important to the competitive well being of many American small businesses to assure the continued availability of the multiple employer welfare benefit trust mechanism. The benefits packages of life and health insurance, and severance benefits payable when termination is unexpected and without cause, are significant tools for small business' ability to attract and retain quality workers.

However, the rules governing 419A(f)(6) plans need clarification. The proposal we offer, which makes clear that all plan assets are available to pay benefits to all plan participants, eliminates the possibility of offering benefits on a discriminatory basis, and appropriately limits the annual deduction available for the funding of these benefits, solves the concerns of policymakers who seek to prevent misuse of IRC Section 419A(f)(6) as way to circumvent pension limits and/or provide deferred compensation, or as a tax shelter for owner-employees and/or key workers, but at the same time assures the continued viability of the 419A(f)(6) plan.

We respectfully request and encourage Congress to enact this proposal, as swiftly as possible.

Thank you. We would be happy to discuss any part of this proposal or issue in more detail. You can contact us directly at 949/655-1401, or through our Washington representative, Dani Kehoe, at 202/547-7566.

Submitted by: Judith A. Carsrud
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MULTI-BENEFIT EMPLOYER PLAN FOR TEN OR MORE EMPLOYERS
REFORM OF SECTION 419A(f)(6)

Proposal Embodied in HR 2370

March 2001

Funding Requirement	At all times, all plan assets must be available as a single, undivided pool to provide benefits to the covered employees of all individual employers participating in the plan. The definition of experience rating will apply as defined by the Tax Court in June, 1997 in *Booth v Commissioner*, 108 TC 524 (1997)
Benefits available from the plan, on a nondiscriminatory basis	Plans will be non-discriminatory: (1) Participation in plan benefits will be provided to any employee meeting these standards: Age 21, 1,000 hours of service annually, one year of service. (2) All benefit formulas must provide a uniform multiple of compensation to all participants (3) A look-back rule would apply at employer termination from the trust, to include all former eligible employees terminated 24 months prior to employer termination from the trust. All eligible employees would be entitled to a prorata share of a plan's assets. (4) Each employer plan must benefit at least one non-owner employee for each two owner-employees who benefit; trust must benefit at least three non-owner employees for every owner-employee benefited
Distribution rules for benefits and plan assets	***In General***: No assets of the plan may revert to the employer. No assets may be loaned to an employee participant. An employer can only terminate its participation based on a bona fide business purpose. ***Forfeiture Pool:*** All assets in forfeiture pool must be used in a nondiscriminatory manner solely for the benefit of plan participants. ***For employers without severance benefits:*** An employer can only terminate its

	participation if all employees of the employer receive a pro-rata share of the plan assets. ***For employers with severance benefits:*** If an employer offers severance benefits, the plan assets used to fund the severance benefits cannot be distributed for a purpose other than severance benefits, which are limited to 200% of compensation (as defined in IRC Section 401(a)(17)) and payable over not more than 24 months, as defined under DOL Regulation 2510 3-2(b), or other benefits as provided under the plan. ***For employers with post-retirement medical benefits:*** No assets used to fund post retirement medical benefits can be distributed for any reason other than post-retirement medical benefits. If a plan participant—including the owner—dies prior to using all his/her post-retirement medical benefits, the unused amounts revert to the plan (a forfeiture). Even when a participating business terminates participation in the plan due to insolvency, sale, merger-acquisition, or other Treasury-approved event, assets attributable to post-retirement medical benefits must stay in the plan until/unless they are paid in the form of medical expense reimbursement. ***Rollover:*** The trustee to trustee transfer of benefits from one multiple employer welfare benefit plan to a similar multiple employer welfare benefit plan will be permitted and not cause constructive receipt to a plan participant.

Benefit Levels	***Death Benefits:*** (1) The maximum benefit will be governed by the life insurance company providing the benefits and by the life insurance industry's standard financial underwriting guidelines. (2) Minimum death benefit amounts will be determined either by the plan's formula for benefits or by the life insurance company's minimum issue, if greater than the plan formula. ***Severance Benefits:*** (1) The maximum severance benefit will be in accordance with Department of Labor regulation 2510 3-2(b) (not in excess of 200% of compensation), with countable compensation limited by pension law (IRC Section 401(a)(17) ***Post-Retirement Medical Benefits:*** (1) Normal retirement would be the year of eligibility for Medicare or total and permanent disability, as defined by Social Security (2) Forfeiture: Assets to fund these benefits remain in the plan to pay benefits. If benefits are never collected, the result is a forfeiture of those assets to the welfare benefit trust. (3) Pre-retirement death of the employee: medical reimbursement funds would be available to pay any uncovered medical expenses of the deceased employee's estate.
Cost of Benefits	Deductions would be limited to: ***Death Benefits:*** (1) If term insurance, the annual term insurance premium (2) If whole life insurance, the level annual premium to normal retirement age (non-vanish) contract premium

	(3) If universal life, the guideline level annual premium (IRC Section 7702). The Section 7702 guideline level annual premium is the level annual premium amount payable over a period not ending before the insured becomes age 95, computed in the same manner as the guideline single premium, except that the annual effective rate remains at 4% (IRC Section 7702(c). ***Severance Benefits:*** (1) Reasonable actuarial principles to purchase the level benefit stated in the plan document (2) No prefunding in excess of the current level of liability for the stated level of benefits annually. ***Medical, health, disability benefits:*** (1) Insurance company premiums, and self-funding up to deductibles and elimination periods. But, self-funding would be subject to forfeiture at an employee's death or termination or termination of an employer from the welfare benefit trust.
Application of new rules to existing plans	These new rules would be effective as of the date of enactment, but benefits earned as of the date of enactment would be grandfathered at their existing level and previous deductions would be grandfathered at their existing level, if the plans are brought into compliance within 24 months of enactment

Contact: Judi Carsrud (949/655-1401), or Dani Kehoe (202/547-7566)

COALITION TO PRESERVE AND PROTECT STOCK OPTIONS

(Promoting Innovation and Economic Growth through Employee Ownership)

April 18, 2002

The Honorable Max Baucus
Chairman
Senate Committee on Finance
United States Senate
Washington, DC 20510

The Honorable Charles Grassley
Ranking Member
Senate Committee on Finance
United States Senate
Washington, DC 20510

Re: Coalition Statement for the Record on Senate Finance Committee Hearing on Corporate Governance and Executive Compensation, April 18, 2002 - <u>Oppose S. 1940, the Levin-McCain Stock Options Tax Bill</u>

Dear Senators:

The undersigned trade associations ask that you oppose the stock options tax bill, S. 1940, recently filed by Senators Levin and McCain. This legislation, if enacted, would:

- discourage broad-based, rank-and-file access to stock options;
- lead to investor confusion and less accurate financial statements; and
- raise taxes on companies issuing employee stock options.

Proponents of this legislation erroneously claim Enron's accounting for its employee stock options significantly contributed to its collapse. The stock options granted to Enron's employees were fully and clearly disclosed in its financial statements and had little if anything to do with its downfall.

We strongly support responsible reforms that will respond to the real causes of Enron's collapse. S. 1940 will needlessly inflict harm on employees who have benefited from broad-based options plans, investors who seek transparent, accurate data on financial statements, and businesses, large and small, that are seeking to build our economy out of recession unburdened by unfair tax increases.

601 Pennsylvania Avenue, NW • Suite 600 • North Bldg. • Washington, DC 20004
• (202) 682-4454 •

Again, we urge you to oppose the stock options tax bill, S. 1940, filed by Senators Levin and McCain.

Sincerely yours,

AeA (American Electronics Association)
American Bankers Association
American Benefits Council
American Business Conference
American Frozen Food Institute (AFFI)
Arizona Software & Internet Association
Beer Institute
Biotechnology Industry Organization (BIO)
The Business Roundtable
Business Software Alliance
California Healthcare Institute
Electronic Industries Alliance
ERISA Industry Committee
Financial Executives International
The Financial Services Roundtable
Grocery Manufacturers of America
Information Technology Association of America
International Mass Retail Association
Labor Policy Association
National Association of Manufacturers
National Association of Stock Plan Professionals
National Food Processors Association
National Retail Federation
National Soft Drink Association
National Venture Capital Association
Securities Industry Association
Semiconductor Equipment & Materials International
Semiconductor Industry Association
Snack Food Association
Society for Human Resource Management
Software & Information Industry Association
Software Finance and Tax Executives Council
The Technology Network (TechNet)
U.S. Chamber of Commerce

ShawPittman LLP

A Limited Liability Partnership Including Professional Corporations

Thomas J. Spulak PC
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May 2, 2002

Honorable Max Baucus
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Re: Corporate Governance and Executive Compensation (April 18, 2002)

Dear Mr. Chairman:

We are writing to you on behalf of our client, James R. Lynch, to ask for your assistance in addressing a tax problem that was no doubt unforeseen by Congress. It arises from terribly unfair language in a subprovision of Section 83 of the Internal Revenue Code (the "Code"). The unfairness is so great that, unless the statute is corrected, the artificial tax liabilities created by it will cause great harm and potentially bankrupt Mr. Lynch and his family, and other families like them.

The problem arises from the fact that, with very limited exceptions, Section 83 of the Code generally requires a taxpayer who receives and later exercises a nonqualified stock option to be taxed on the market value of the stock in question as of the time that the options are exercised—even if the taxpayer is barred *legally* from selling the stock at the time it is valued for tax purposes whether to obtain cash to pay the taxes resulting from the date imposed by Section 83 for valuing the stock, or otherwise. This rule is in stark contrast to the prevailing mandates regarding the timing of income taxation, which do not require a taxpayer to report the value of earnings until the earnings are available to him or her without substantial limitations or restrictions.

This rule regarding nonqualified stock options can result in the taxation of phantom income—market "value" that disappears by the time that the taxpayer is legally allowed access to the market. This problem is somewhat parallel to, while also distinct, from, that addressed in the legislation proposed by Senator Lieberman (D-Connecticut), S. 1142, which relates to the application of the Alternative Minimum Tax ("AMT") to incentive stock options ("ISOs") at a time when taxpayers are prevented from selling the stock because it would result in a loss of tax benefits. The case for providing relief for taxpayers caught with nonqualified options governed by Section 83, that cannot be sold legally, is similarly compelling to the case that has been made for relief from the AMT provided in the ISO legislation.

Mr. Lynch helped found a computer hardware company called Liberate Technology ("Liberate"), which is located in San Carlos, California. He worked for Liberate for approximately three and a half years, until June 1999. He was employed by the company as a consultant for a period thereafter. While he was employed by Liberate, he was granted non-qualified stock options to purchase Liberate common stock. As you know, stock options were then, and still are, a common means of compensation in the computer industry, especially among young companies, which often lack the cash flow to pay competitive cash salaries.

Liberate decided to launch an initial public offering ("IPO") in July 1999. In connection with the IPO, Mr. Lynch was required, as is the almost universal practice in such situations, to submit without qualification to a lock-up agreement prohibiting him and all other option-holders from selling any stock on the market received on the exercise of the option, for 180 days after the IPO—or, as was the case of Mr. Lynch and all others at the company at the time, until January 26, 2000.[1]

Mr. Lynch's stock options provided that they would expire if they were not exercised within 6 months after termination of employment—or by January 11, 2000. As a result, he was compelled to exercise his options during the IPO lock-up period. He did so on January 3, 2000. When Mr. Lynch exercised his options, the trading price of Liberate's common stock was approximately $246 per share. By the time the lock-up expired and he was legally allowed to sell the shares in question, the market price of Liberate's stock was substantially lower, and it has continued to drop since that time.

Under Section 83 of the Code, when Mr. Lynch exercised his stock options, he was required to recognize income equal to the difference between the full *exercise-date* market price of the stock he received and the exercise price of the options. As a result, he and his family incurred a massive artificial tax liability based on a value in a stock market to which he had no legal access until after the end of the lock-up period.

Congress at least provided relief for individuals on the highest rungs of the corporate ladder when a comparable problem became evident. Specifically, Congress provided an exception from the operation of Section 83 for individuals who are directors, executive officers

[1] Lock-ups are imposed to avoid disrupting the market for a company's stock while the company is trying to sell a large block of stock to raise capital. One hundred and eighty days (or six months) is a standard lock-up period. Employees often must agree in writing in advance in their stock option agreement to be subject any lock-up imposed by the company and its underwriters as a condition of receiving the stock option.

or significant shareholders of public companies and therefore subject to Section 16(b) of the Securities Exchange Act of 1934. Under Section 16(b), such individuals can be required to disgorge any profits they earn from buying and selling company securities within a six-month period. The result is that these individuals may be effectively prohibited from selling any company securities they own during certain periods of time. Section 83 provides that, if a Section 16(b) insider receives securities from his or her employer, such as by exercising a nonqualified stock option, and the insider's sale of the securities could subject him or her to suit under Section 16(b), then the insider is not subject to tax—because the market value of the securities is not considered—until just after that risk disappears so that the insider can legally sell the stock in the market, for example, to raise cash for his or her taxes on the exercise of the option. While Mr. Lynch was one of the founders of Liberate, he was not a Section 16(b) insider and therefore was not able to benefit from this special rule.

The plight of Mr. Lynch and his family is similar to the plight of employees from all levels of a corporation—like those of Enron Corporation—forced to experience a loss by being prohibited from selling company stock as a result of legal limitations imposed on them—particularly for the convenience of the employing company and its underwriter during a period while the stock is declining in value. In situations like that of the Enron employees, the loss results from the use of cash contributions to a retirement plan to purchase company stock that ends up being worth much less than the cash. In the case of Mr. Lynch and his family, and all others like them, the loss results from the current "*catch 22*" premature timing of the valuation of the optioned stock that cannot be legally sold until later when its value has become diminished.

Mr. Lynch's family and others like them will not survive financially without an amendment to Section 83 that would provide that individuals — not just the presently-protected controlling officers and shareholders and directors of public companies— -- who are prohibited from selling stock received upon exercise of a nonqualified option not be, taxed based on the value of the stock that they receive until they are *legally* able sell it. The amendment that we hope you will support would delay the date of taxation under Section 83 for—in addition to persons potentially subject to liability under Section 16(b)—persons who are unable to sell stock because the sale would violate a bona fide IPO-related lock-up agreement such as the type that has threatened to devastate the Lynch family and the others like them. This amendment, like the proposals relating to the application of the AMT to ISOs, would be retroactive to January 1, 2000—close to when the current market turbulence, which served to highlight the current bias of Section 83, began.[2]

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[2] The proposal has not been drafted with a view towards retroactively reducing employers' deductions related to the transfer of the stock in question.

Such a modification of Section 83 would result in a more equitable taxation of nonqualified stock options, and help reduce the hopefully-unintended artificial tax burden that has been placed on employees who already are facing a loss of savings because of the decline in value of their employers' stock during lockups.

The relief that our client is seeking has received the support of the American Institute of Certified Public Accountants and the California Society of Certified Public Accountants. Copies of their letters of support, one of which was addressed to you earlier this year, are attached. We would very much appreciate your leadership in remedying the inequities of Section 83 by supporting the enactment of a provision similar to that which is described in this letter.

Very truly yours,

Thomas J. Spulak, Esq.
ShawPittman LLP