

Merrill E. Newman
1256 Martin Avenue
Palo Alto, CA 94301
650-327-8086
seamerrill@aol.com

Letter of Comment No: 4969
File Reference: 1102-100

June 21, 2004

Hon William H. Donaldson, Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Dear Mr. Donaldson:

I have been living and working in the Santa Clara Valley since 1956, long before it became Silicon Valley, and have observed and been through many changes. The Stock Option phenomenon is one of the most significant and I would like to comment on this as an observer, participant and system administrator.

In the technology world we have here in the valley, the application of stock options has grown to include, in many cases, all employees, based on the belief that aligning the interests of all employees to the interests of the shareholders was in the ultimate best interests of the shareholders, a theory with which I concur.

As with many good ideas, the system has gotten out of hand and we now have a major force pushing for "stock option expensing". The fact that we have no honest way of valuing stock options at the time of grant – when conventional accounting theory requires the "expense" to be recorded – has been lost in the pressure to reflect the enormous incomes often reported by executives. The backlash should be expected and, although many of the exercised options were granted and held for several years, the gains can only be considered obscenely excessive.

THAT IS NOT THE PROBLEM! The real problem is the rule change made by the SEC in 1991 which removed stock options from the application of the short-swing rule for those officers and directors covered by Rule 16(b). This was a terrible mistake at the time and continues to be a terrible mistake leading to most of the problems of excessive compensation, cooking the books, calls for option expensing, etc.

I have reviewed the letter of November 12, 2002, from the Committee on Federal Regulations of Securities of the American Bar Association's Business Law Section and believe their reasoning is incorrect in recommending that the 1991 changes should not be revisited. The economic effect of stock options really only occurs upon exercise, not upon grant. I have had many options granted which were never exercised, as well as options exercised. There is a BIG difference in the economic effect!

With the ability to exercise and sell on the same day, the executive has NO risk. He(she) can pressure the Board to make huge option grants which would make no sense if the executive were still required to exercise and hold the stock, fully paid, for the 6 months as required before the 1991 rule change. Almost no executive would be confident enough to invest the cash required to exercise a 100,000 share option and hold it for 6 months, let alone options several times that size, as is often the case.

This situation has also led to grants of excessive (in my view) option grants at all levels within the organization. When the most senior executives are granted very large options, the option grant inflation certainly runs through the organization; thus the apparently reasonable demand that the economic effect of this shows up in the income statement of the corporation. Pre-1991, there was almost no call for this accounting treatment – mostly because the total dollars involved were very much less significant.

I urge the SEC to reverse the 1991 ruling and return to the application of the short-swing rule to stock options, as well as other similar transactions. I truly believe that this would solve more problems in corporate governance than any other single action that the SEC could take. I fully realize that it is much more politically difficult to reverse the 1991 rule change than it was to make that change. Nevertheless, I believe that it is a very important obligation of the SEC to do so.

I would be glad to discuss my views with the Staff of the Commission at any time.

Very truly yours,

Merrill Newman

Cc:

Hon. Cynthia A. Glassman, Commissioner
Hon. Harvey J. Goldschmid, Commissioner
Hon. Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner

Bcc:

Senator Dianne Feinstein
Senator Barbara Boxer
Congresswoman Anna Eshoo
Chairman Robert Herz, FASB