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Financial Accounting Standards Board
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Letter of Comment No: 106
File Reference: 1102-100

This is written, good people, concerning your proposed new rule that would require corporations to count employee stock options as a business expense.

I offer my complete and whole-hearted approval of this requirement. I am convinced that this rule would strongly inhibit, if not prevent, a considerable amount of the corporate fraud we've suffered in recent years.

I write as a relatively-small shareholder (my wife and I hold a portfolio, mostly in equities, of about \$3,000,000). While each of us has received a small inheritance from our respective parents, the great bulk of our investment portfolio found its origin in prudent living and systematic saving over a lifetime . . . savings that have been invested with the help of some excellent advisers and an honest brokerage firm (Wm. Blair & Co., Chicago). As I read the annual reports issued by the corporations in which we hold stock, I am astonished by the manner in which our share of the company ownership is diluted by the issuance of enormous quantities of stock in a variety of methods: options, special stock, restricted stock, deferred stock to be issued in the future, etc.

As small shareholders, we're helpless to protect our investments from what is--to put it bluntly--legal theft. That's why we need the kind of rule you now propose about options . . . another opportunity for the U.S. Government to protect citizens' property. As Warren Buffet remarked a few years ago: "If stock 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 do they go?"

Even more important is the growing gap in income as between (a) the wealthiest families and (b) those people whose income is below the median . . . about half the population. To the extent that executive options enhance this trend, they contribute to the possibility (likelihood?) of a major economic depression that would damage our nation and its economy in ways we cannot anticipate. This is what happened in the 1920's: As the income gap between rich and poor grew ever larger, unemployment steadily rose (and family-farm income, then far more important than in this century, steadily fell) throughout the decade. The result: The Depression of the 1930's, which had world-wide repercussions that (in part) helped bring about World War II.

In short: Your proposed new rule will certainly improve the economic health of our nation and of the world . . . an action important in its own right.

You may be interested in the enclosed clippings from The New York Times reporting on the adverse effects of executive options, as well as this book describing corporate scandals before creation of the SEC: Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (New York: Macmillan, 1932; rev. ed., Harcourt, Brace & World, 1967).

Finally: Many people argue that if corporations must expense stock options, they'll stop offering them. That would be a good thing. Indeed, about three years ago I wrote to the Business Editor of The New York Times suggesting that all compensation should be paid in cash so that employee costs would be correctly reflected in the bottom line . . . corporate profits. She didn't print my letter--but did hand-write an answer suggesting that my idea was too rational to be adopted.

Perhaps your proposed new rule on expensing options will have the same effect . . . end executive compensation through the (mis)use of options. If so . . . good for you!

Cordially,



Leonard S. Stein, Ph. D.

SUNDAY, AUGUST 11, 2002

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p. 4

ECONOMIC VIEW

DAVID LEONHARDT

Options Do Not Raise Performance, Study Finds

THE downside to stock options has become spectacularly evident in the last year or so. They can give executives an incentive to inflate their company's earnings or make irresponsibly optimistic forecasts to keep their stock prices high and their paychecks lavish.

With executive indictments continuing, the benefits of options are easily forgotten. Enron and its brethren aside, however, isn't the economic rationale for awarding managers stock to align their interests with those of shareholders as solid as it has always been?

No — and it was never really as solid as it seemed, says a new paper that will be presented tomorrow at an academic conference in Denver. Combining more than 200 studies over 30 years to create the largest possible sample, the paper finds that the amount of equity executives own does not affect their company's performance.

"There's no relationship whatsoever," said Dan R. Dalton, the dean of Indiana University's Kelley School of Business and one of the paper's four authors.

The conclusion is hardly intuitive, coming after years in which investors and executives hailed stock ownership as a solution to the age-old problem of how to ensure that people who run but do not own a business act in the best interests of the owners. Adam Smith noted the problem in 1776, writing, "negligence and profusion, therefore, more or less, in the management of the affairs of such a company."

The recent stock market bubble has shown that negligence and profusion can prevail, and investors can turn a blind eye to them, even when executives own large stakes in their company. Now that some investors want to reform executive pay, the new findings deserve a place in the debate.

When scientists talk about the relationship between two variables, they like to use the numbers zero and one. Measuring the relationship between the height from which a ball is dropped and its speed when it hits the ground, for instance, will yield a number very close to one, showing a nearly perfect correlation. The relationship between the latitude of an American city and its average temperature will fall between zero and one — a significant correlation but not close to perfect.

The relationship between executives' stock holdings and their companies' performance is so close to zero that it is zero in statistical terms, the paper says. This means that an alphabetical ranking of companies is as apt to predict their performance as a ranking based on executives' holdings.

A number of explanations are possible. Other incentives, like cash pay and an executive's reputation, may be as strong as stock in motivating executives. Even if stock is a powerful incentive, the strength of the economy and the long-term health of a company may determine its results more than a group of executives can.

"It's possible that we attribute far too much control to executives relative to what they actually possess," Mr. Dalton said.

The researchers looked at a long list of performance measures, and the only one that seemed even slightly related to executives' equity was the easiest for managers to manipulate: earnings per share. Executives can lift that figure by directing the company to buy back shares or cut its dividend payments.



Dan R. Dalton

Buying back stock may not be ideal for the company, but it is likely to lift the stock price at least temporarily.

"You have to step back and ask yourself who is attending to the long-term interests of an organization?" said Catherine M. Daly, a professor at Indiana and one of the authors. "No one." The other authors are S. Travis Certo of Texas A&M University and Rungpen Roengpitya of Indiana. The paper will be presented at the annual meeting of the Academy of Management.

THE paper's conclusions are not wholly original and are not likely to be the last word on executives' stock holdings. Many economists believe that equity can affect performance but only when it is part of a more complicated corporate governance strategy, a possibility the authors do not dispute. Ira Kay, a compensation consultant who has read the paper, said the fact that the studies on which the paper is based dated to 1970 gave him hope that a new study would produce different conclusions.

"A lot of the studies are old and were done before there was significant stock ownership, which is what it took to have an effect on performance," Mr. Kay said.

For now, however, skepticism is in order. When executives receive enormous grants of stock or options, they like to say that they are acting in the interests of their investors. The executives might be more credible if they simply said they thought they deserved a lot of money. □

during the period studied, included Weatherford International, an oil services concern; the Edergen Corporation, an energy holding company; and Harvest Natural Resources, an oil driller.

"The assumption that the system is better for everybody by giving most of the pie to the top of the hierarchy is an assumption that is widely accepted by lawyers, accountants, Wall Street investment bankers and even by many academics," Mr. Blasi said. "But when you compare companies against each other, the more you increase the option grant to the top five executives above the mean, the worse your shareholder return gets."

Perhaps in reaction to investor ire about excessive executive compensation during the stock market's fall, no company gave 100 percent of its options to top executives in 2001, and only three gave more than 90 per-

Options

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cent. And the median share granted to the top five executives fell to 18.2 percent in 2001, from a high of 28 percent in 1994.

It is perhaps not surprising that as the stock market climbed throughout the 1990's, more and more companies were giving their top executives larger-than-average option grants. Investors did not seem to mind the transfer of wealth that these option grants represented, maybe because the investors themselves were making money on the stocks.

In 1992, for example, only 375 companies exceeded the average percentage given by companies to their top executives. But that number rose steadily during the decade, to 733 in

1998. The number has since tumbled: last year, 226 companies gave their top executives more than the average grant.

Mr. Kruse, who is also a research fellow at the National Bureau of Economic Research in Cambridge, Mass., said his study underscored the need for institutional investors to be vigilant about huge grants.

"While institutional investors are enjoying beating up on executives these days," Mr. Kruse said, "one sad implication of these results is how they actually point the finger at those same institutional investors for leaving corporate governance to the wrong people."

"Anyone who claims there hasn't been a systematic corruption of business as usual using the legal system as a front, compensation consultants as handmaidens and corporate human resources staffs as lackeys doesn't understand what's gone on." □

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When Options Rise to Top, Guess Who Pays

By GRETCHEN MORGENSON

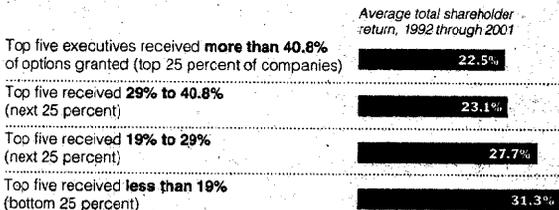
BY proposing last week to make companies deduct the cost of stock options as they would any employee cost, the International Accounting Standards Board may finally be moving the corporate world closer to uniform treatment of this wildly popular and decidedly American form of executive pay. But the debate is not about to stop.

The board's move, which would make corporate accounting for stock options reflect reality, is already drawing fire from technology company executives and their lobbyists who favor keeping option costs out of corporate profit-and-loss statements. Proponents of the status quo argue that if options must be reported as expenses, companies will no longer dispense them.

Some say option grants are the best way to align the interests of executives with those of outside shareholders. Others, like Senator Joseph I. Lieberman, Democrat of Connecticut, contend that if companies stopped dispensing options, rank-and-file

Less Is More

A study of the 1,500 largest corporations found that those that awarded the biggest share of their stock options to the top five executives had the lowest returns for shareholders.



Source: "In the Company of Owners" by Joseph R. Blasi, Douglas L. Kruse and Aaron Bernstein.

The New York Times

workers who receive them would be most hurt.

Now, though, a new and comprehensive academic study soundly disproves both ra-

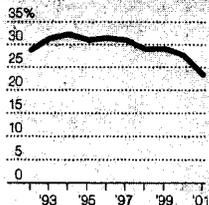
tionales, giving shareholders more reason to reject new pay packages skewed in favor of top managers or not adequately linked to short- and long-term performance.

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When Options Rise to Top, Guess Who Pays

Smaller Slices

The average share of total option grants received by the top five executives at the 1,500 largest companies has declined recently.



Source: "In the Company of Owners" by Joseph R. Blasi, Douglas L. Kruse and Aaron Bernstein.

The New York Times

executive pay packages that pour on the options.

"I think companies are going to be shocked this season," he said.

Mr. Blasi said his study "strongly suggests that executive excess in stock options did not help total shareholder return over the entire decade.

"The problem," he added, "is not a few bad apples but the entire system of executive compensation which was created by a compromised system of corporate governance."

Carol Bowie, director of governance research services at the Investor or Responsibility Research Center in Washington, says investors have rapidly become wary about stock options. "At the very least, options tended to promote a short-term focus," she said, "and at worst, they

promoted fraudulent activity to manipulate earnings."

In their study, the professors looked at how widely companies had distributed options among their employees. Over the 10 years beginning in 1992, the median percentage of options going to the top five executives was 29 percent.

But companies that dispensed significantly more than the median — like R. R. Donnelley & Sons, which in 1997 handed out 94 percent of all options to its top five executives — disappointed in two respects. They produced lower overall returns to shareholders than did companies that dispensed less than the median and generally underperformed the overall market as well.

The study is part of the professors'

A study says options didn't work as promised.

forthcoming book, "In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them," to be published by Basic Books on Jan. 7. They researched and wrote the book with Aaron Bernstein, a senior writer at Business Week.

The professors ranked 1,500 companies according to how much of their options they awarded to their five most senior executives. The 375

Joseph R. Blasi and Douglas L. Kruse, professors of human resource management at Rutgers, examined stock option grants and shareholder returns at the 1,500 largest American companies from 1992 to 2001. They found that companies dispensing significantly larger-than-average option grants to their top five executives produced decidedly lower total returns to shareholders over the period than those dispensing far fewer options.

As for the notion that options are primarily a rank-and-file perk — and that abandoning them would hurt lower-level employees — the study instead confirmed what many investors have suspected: in recent years, most options have gone to top executives. And that has been true at hundreds of companies, from Campbell Soup and United States Steel to the El Paso Corporation and the Rowan Company.

Patrick S. McGurn, vice president at Institutional Shareholder Services, a shareholder advisory service in Rockville, Md., said that the study would fuel a movement among pension fund managers and other institutional investors to start rejecting ex-

that gave the most to their top executives — more than 40.8 percent of all options — performed worst, returning 22.5 percent over all to shareholders through 2001. The 375 companies that gave the fewest options to their senior executives — less than 19 percent — fared the best, giving investors a 31.3 percent return, on average.

After combing through the data, the professors said they were surprised by the number of companies that chose to hand over their entire annual stock option grant to just five top executives in any given year. According to regulatory filings from 1992 to 2001, an average of 11 companies a year gave all their options to five executives.

Companies that did so in one year