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January 30, 2003

Letter of Comment No: 444 File Reference: 1102-001

Date Received: 1-30-0

Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

RE: Public Comment on Stock Options Expensing

Gentlemen:

My letter to you of January 22, 2003 regarding stock options reflects my personal views and not those of the NASDAQ Stock Market, Inc.. I apologize if the NASDAQ letterhead gave the impression that it was the official position of NASDAQ.

Sincerely,

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Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: Public Comment on Stock Options Expensing

Gentlemen:

Something important is being lost in the current debates about stock options. The arcane details of accounting and taxation are not the important issues. The balance of power between managers and shareholders is not the important issue. What is important is that America provides a way for smart, hardworking people, entering the workforce with nothing but their wits and their energy, to have a way to earn ownership of a significant share of the productive assets of the economy. Broadspread ownership of our productive assets is the surest, safest way to a rising standard of living and political stability.

For hundreds of years, people have come here for economic opportunity. At first, it was for land. Our first "option" program was the Homestead Act, which, like today's option programs granted ownership in return for labor over time. A deep understanding of the relationship between ownership and a stable society manifests itself in various programs that encourage home ownership - from veteran's loans to the home mortgage interest tax deduction. Don't think for a minute that these principles are limited to the corporate world. The link between ownership and a stable society are profound. How many times have you heard that the war in the middle east is a result of Palestinian's desire for a "land of their own." That means "A land that they own." There's more. There is a continuum of correlation between stability in society and the ability of individuals to own productive assets. Hernando DeSoto's The Mystery of Capitalism documents the instability caused by the lack of clear title to productive assets, like land. His insights clarify the sources of discontent, and its geopolitical ramifications around the world. It is highly likely that behind the veneer of religious fundamentalism is economic discontent. The inability to own and accumulate productive assets is at the heart of the discontent that drives able-bodied people to street protest, guerilla warfare, and terrorism.

A stable society is necessary (but not sufficient) for economic growth and a rising standard of living. Our citizens need to own more than a house, given our extended life expectancy and, more importantly, given the changing demographic composition of America.

In America, stock options are the modern equivalent of the Homestead Act, and are the only way for most American's to have a prayer of owning a significant piece of a productive asset – the company for which they work. Employee ownership is good for the corporation as well as the employee. There is no better example than Herman Miller, Inc.

Max Dupree, son of the founder of Herman Miller Inc, writes about employee ownership in Leadership Is an Art.

"Today we are one of the few public companies in the United States where 100 percent of the full-time regular employees in the U.S. who have completed one year of service are stockholders. These two roles bring responsibilities and rewards....

"At Herman Miller, there is an owner and an employee in every position...
Employee stock ownership is essential to a declaration of identity. Motivating is not a significant problem: Herman Miller employees bring that with them by the bushel. But people need to be liberated, to be involved, to be accountable, and to reach for their potential. We believe that more and more working owners are winning the struggle for identity and meaning against anonymity and frustration."

"Employee stock ownership is also clearly a competitive reality. Nothing is being given. Ownership is earned and paid for. The heart of it is profit sharing, and there is no sharing if there are no profits. Risk and reward are connected logically and fairly."

"There is no smug condescension at play here. Rather, there is a certain morality in connecting shared accountability as employees with shared ownership. This lends a rightness and a permanence to the relationship of each of us to our work and to each other."

<u>In the Company of Owners</u>, a new book by Blasi, Kruse and Bernstein, documents increases productivity in companies with broad based option plans, and benefits to the overall economy.

If ownership is key to a stable, productive economy, ownership is also important to the long-term financial well being of the worker. We have stacked the deck against labor in the United States, with low wages, progressive taxation and deflationary effects of global competition. In a tax system promoting consumption and penalizing savings, we compound the difficulty of saving with forced retirement and medical advances that will keep us alive for twenty years after we retire. Equity is the only financial instrument that

offers the possibility of growth, and is essential for million of Americans. America helps itself by encouraging broad ownership of equity.

Think of the alternatives. What America needs to avoid is the stultifying lack of opportunity that characterizes Europe and much of the world. We need broad, democratic ownership of the productive assets of the economy, not a small financial elite controlling more and more of the economy. The battle between the old and the new, between entrenched financial capital and aspiring intellectual capital seems to have been already decided in Europe. Old class attitudes probably sealed the fate of stock options in Europe. Whatever the reason, they are rare and an awful lot of Europe's best talent has come to the U.S. for economic opportunity. As a result, Europe has missed leading in wave after wave of innovation, and when it has a hit, like wireless communication, the spoils are not distributed widely.

The efforts to democratize ownership in Europe had many enemies. Underlying class consciousness, wide spread poverty after WWII, the re-emergence of pre-war wealthy elites, and political responses to the threat of Communism all contributed. In an effort to rebuild Europe as rapidly as possible after WWII, American reconstituted several large banks in each country. They did what banks are meant to do: lend money. Europe rebuilt on debt, not equity, as a result. Europe is a debt oriented, rather than equity oriented economy. It is estimated that fewer than 20% of European households own equities, as opposed to 50% in the U.S.

In an effort to block Communism, <u>labor</u> was given a large role in corporate governance – a majority minus one on management committees in Germany, for example. Labor's dreams and aspirations are focused on those union leaders. Labor's power runs through them. The last thing they want is for union members to be owners or to think like owners.

<u>European wealthy elites</u>, the handful of families that own the largest share of Europe's productive assets, control as much as they can by interlocking holdings, interlocking boards, and multiple classes of equity shares. These legal structures are designed to limit access by newcomers. This is financial capital ensconced at its finest. The idea of intellectual capital – smart, hardworking, inventive and "low class" – earning progressively larger pieces of ownership is anathema to ensconced wealth trying to hold on to its relative social position over generations.

In the U.S., stock options are the most logical way to reward intellectual capital, in a winwin way. The decisions are distributed widely in a large number of corporations. Corporations are the unit of production able to both recognize and reward talent. Competition will reward good decisions in talent and punish bad decisions.

But many forces are lining up against stock options. First come the <u>accountants</u>. Like all human endeavors, accounting has its own internal politics and fads. A current fad is to run more and more transactions through the income statement, and to put on the balance

sheet more and more human judgments, particularly about future values. The profession is in the grips of its theoreticians.

At any rate, the accounting profession is in the throes of its own battle for intellectual control, and the more arcane the accounting concept, the more accountants have employment. From an accountant's perspective, the view ahead looks fine. As a member of an accounting industry lobby group gushed to me when Sarbanes-Oxley passed, "That's our language!", referring to the requirement for "financial expertise" in corporate boards. She viewed Sarbanes-Oxley as the Accountant's Full Employment Act of 2002. Investor's need to understand that, while the public debate is couched in moralistic and theoretical terms, politics underline many efforts and special interest economics abound.

There is a fundamental problem if the income statement theorists prevail, and it revolves around the fact that stock options are already accounted for in dilution. The current argument is emotionally charged and ignores the elegant symmetry of Piccolo's approach. This elegant, 400 year old system already account for options, through "fully diluted" calculations. As the manager of the Third Avenue Growth Fund says, "of course stock options are an expense, they are an expense to shareholders, but not an expense to the corporation". Expensing options double counts them, moves financial statements farther from accurate representation, and makes it more, not less, difficult for investors to understand the true condition of their company. Double counting the impact of options will hurt everyone in the long run because it is less accurate, less truthful.

With accountants calling for expensing of options, it makes it particularly easy for others, with other agendas, to pile on. The <u>shareholder's rights crowd</u>, operating in a country where shareholders have more rights than any where else in the world, always needs another initiative to generate conflict and stay in the media. The shareholders rights movement has two elements, the <u>plaintiff's</u> bar, a chorus of <u>pundits and media hangerson</u> and some larger institutional investors. Sarbanes-Oxley requires all stock options to be voted on by shareholders. It is probably an appropriate shift of power from corporate boards to shareholders. Time will tell. This balance between what is best left to boards and what is best left to shareholders is a delicate one. We have to wait to see if there are unintended consequences.

Managers of some large pension funds and mutual funds are actively involved in the shareholders' rights movement. Fund managers have a legitimate seat at the debate and are an interesting contrast to venture capitalists, who are also fiduciaries for other's monies, and who are generally on the opposite side of the stock option issue. Why the difference? Why the stark difference?

Pension fund managers and mutual fund managers are essentially passive fiduciaries. The index funds are quite passive. Even active managers are typically passive when it comes to corporate governance. The situation is so bad that many rely on outside services to advise them how to vote on corporate resolutions. (This has created a separate locus of power in the advisory services, who allegedly abuse this power in sort of an

extortion game, charging companies information about an otherwise opaque voting process, and, allegedly, recommending votes against the resolution's of non-clients.)

There are literally thousands of pension and mutual fund managers. Most under-perform the market indexes. In addition, they are graded to five decimal points against each other in superficial, short term ways that can make or break money flows into or out of their funds, money flows that in turn, can make or break an individual fund manager's career. As a result, most are extremely short term oriented, typically behaving as speculators, not investors. They are against the dilution to their ownership that employee options imply because they don't plan to hold the stock long enough to see the long term improvements created by energized owner-employees cause.

Contrast these passive, absentee fiduciaries to <u>venture capitalists</u>. They too are fiduciaries, managing money for others, often the very same pension funds discussed above. But they are not absentee and they are not passive. They participate actively in the corporate decisions that their investees make, holding board seats, recruiting talent, and profiting directly from the success of the company. And they are passionate advocates of stock options.

What causes the different attitudes about stock options? Passive fund managers tend to see options as a win-lose matter. The more shares optioned away from current shareholders, the less available to current shareholders, and the lower their almighty fully-diluted quarterly profit per share.

Active venture capitalists tend to see options as a win-win matter. The talent attracted by options builds the company <u>more</u> than their options <u>dilute</u> the venture capitalist's share. In other words, where passive fund managers see a closed, static system, active venture capitalist see a open, dynamic system. Therein lies the difference. Static, linear models are easy to portray as "win-lose". Complex dynamic systems are hard to understand and yet can be "win-win".

Passive fund managers either cannot see or do not give credit to management talent for growing the business more than the dilution their options cause. Active venture investors understand the dynamics of growth and the role of talent. They can be patient enough to let growth compound, as they are graded over 7-10 year cycle.

<u>Large companies</u> which do not grow very rapidly and which do not use options widely, are delighted to do anything that makes stock options less attractive, less affordable. They are sick and tired of losing able people to venture backed competitors.

Next come the <u>Europeans</u>, who see options an unfair competition and need to pull us down to their own miserable levels of opportunity and performance. Europe has tried and failed to use options to motivate innovation and spread ownership.

Unable to unleash the creative power of their own economies, Europeans, particularly bureaucrats, are appalled at the willingness of American workers to accept low wages and

willingly work 50 and 60 hours weeks in return for a sliver of ownership in their own business. Using "convergence of accounting standards" as a political grail, they plan to lower America to their own pitiful level of innovation and labor mobility.

There is a certain dog-in-the-manger quality to our own press's approach to these issues. Most reporter's are wage-slaves to mature, consolidated media empires. These smart, ambitious knowledge workers stand almost no chance of earning a lot of money, and even less of earning ownership in the newspapers or magazines they work for. Smart as can be, and oh-so-human, it is easy for them to lash out at stock option schemes that they cannot have. Furthermore the media's current fad is to depend on conflict, and character assassination. It is so easy to condemn stock options as greed on the part of a few managers. At the same time, there is very little conflict in or drama in the slowly accumulating wealth of million of workers receiving broad based options, and hence few reasons for media focus.

The fact that a handful of allegedly crooked CEO's made more than they should have out of options, compounds the confusion and muddies the argument. The heart of this debate is about board based ownership of options, not the abuses of a concentrated elite. There are ways to discourage abuse at the top and encourage broad option grants.

Another knot in the stock option debate involves the fact that it is relatively easy to quantify the "costs" of options (laying aside the absurdity of applying short term option pricing models to illiquid long term options) and difficult to qualify the "benefits" of the driven, focused creativity an option holder creates. In a nation fascinated with numbers and an attention span unable to comprehend either complex dynamic systems or compounded benefits over time, we may embrace a short term, seemingly precise, wrong answer rather than the ambiguities and uncertainties of a more promising, long term, dynamic system.

A third knot in the debate is our instinctive isolationism. We have already begun to see talent and corporations seek opportunity elsewhere. One major technology company, Novellus, lost its chief technology officer, a brilliant fellow, to a start-up in China. The inducements included, guess what, stock options at pennies per share and no taxes on those options. The exodus of major corporations to Bermuda to find a fairer international tax environment is related in that it reflects our attitudes, attitudes that presume we are more competitive than we really are, that we are somewhat isolated from the international competition. We are not.

A fourth knot in the current discussion involves the illogical reference points built into current accounting policy and tax law. Years ago, as a way to encourage companies to grant options, not as a matter of accounting or tax theory, companies were allowed to deduct the value of shares issued to workers. This tax goodie set a precedent that still confuses almost everyone. There was no accounting justification for this deduction, and it should be recognized for what it is, an incentive, or abolished. More on this later.

Additionally, we give favorable tax treatment of options that vest in the basis of service over time, but of tax options that vest based on performance goals achieved. All share transactions should be treated for tax purposes as purchases and sales by employees. Options granted at or above market, and earned through performance, should be taxed when the employee sells the shares. The time value of the options should not be taxed, but should be the nation's encouragement to issue options to employees – a modern Homestead Act.

A formidable array of special interests does not mean that these special interest agenda's are right, or that the opportunity to encourage broad ownership of equity shares through options is lost. The simple truth is that America helps itself most by encouraging ways for newcomers to earn a piece of the American dream. Stock ownership in the productive assets of our economy is essential if all these new faces – brown, black, yellow, white – are to find a stable place in our economy as they become adults and enter the workforce. This economic pie needs to get a lot bigger if we are going to accommodate all those wonderful, smart, hardworking dreamers. Stock options, widely distributed, Federally encouraged, are the best way to grow our economy and are the logical successor to the Homestead Act that served us so well in the past.

Sincerely,

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