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Very truly yours,

Joseph W. Bartlett

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AN ANALYSIS OF COMPENSATION FOR SENIOR PUBLIC MANAGERS ...
AND A PROPOSED ALTERNATIVE TO STOCK OPTIONS¹

by Joseph W. Bartlett²

INTRODUCTION

'Enronitis' has stimulated the suspicion that Corporate America is irremediably corrupt, in turn spreading the malaise which drags the market averages down just as the economy recovers nicely. Good news cannot fix the Dow and NASDAQ, the troubles of which in turn may reverse the good news.

The Administration appears hapless, in part because its options are so limited. On the one hand, massive government regulation is a cure worse than the disease; on the other hand, simply jawboning and increasing the penalties for crimes already on the books is perceived (correctly) as doing nothing.

The following paper suggests a new approach, which recognizes certain realities in today's ugly climate (including the above-named) and attempts to (i) understand and accommodate them; and (ii) leap-frog the current quagmire.

First, some realities as I see them, namely:

- Stock options, *per se*, are not the problem. Most of the attacks on options are lamentably uninformed.
- However, the 1997 FASB failure to require expensing options as of the date of grant has acquired iconic importance ... a "reform" which now must happen to combat corporate "greed." The fact that the "reform" is (a) unnecessary and (b) unlikely to have much impact is beside the point.³
- The ability to pay the help with options has been critical to the success of the venture capital-driven, hi-tech miracle in this country (the envy of every competitive economy) for three reasons:

¹ Long form version of paper published in *Innovation Review, Intelligence from the Berkley Center for Entrepreneurial Studies*, Bartlett, "To Expense or not to Expense? Looking for a third option in the great stock option debate," Fall 2002.

² The views expressed herein are my own and do not represent the views or opinions of my firm or any entity with which I am affiliated.

³ To show how irrelevant the "reform" is, AOL is considering the current expense alternative which FASB 123 allows. AOL will incur significantly increased charges to earnings, of course, but AOL seeks to trade on the basis of cash flow; as the old saying goes: "GAAP is an opinion; cash flow a fact." If AOL is willing to throw in the towel on this issue, what is the fuss all about? Even more alarming (see the principle of unintended consequences), Barry Diller has announced that USA Interactive will (i) expense option grants and (ii) in the future give up the plan entirely in favor of restricted stock grants, because options are "far too democratic."

(i) It ties reward to performance. *Nota bene*: Performance driven pay, ironically, was the battle-cry of the “reformers” in the ’80s; management was then accused of neglecting the stock price, wedded to their fixed salaries and cushy, non-stressful jobs. Today’s “reformers” are, by and large, the same people, but they have done a 180° turn.

(ii) The corporation does not use cash ... which, in the case of venture-backed start ups, none of them have.

(iii) Tax is postponed until the employee realizes cash ... and can, therefore, pay the tax.

- If stock options are the required sacrificial lamb, the equivalent of the human sacrifice which cures the primitive tribe of its angst, then some regime has to be installed in their place, hopefully a regime which can be better calibrated to where we as a society want to go ... *i.e.*, pay rationally tied to long term performance with little or no built-in incentives to cheat.

- The root cause of the problem cannot easily be fixed but only recognized and dealt with because it is not based on the CEO’s greed or independent bias towards criminal behavior; the problem’s foundation lies in the climate in which a typical CEO operates ... *i.e.*, today’s market insistence on quarter-by-quarter performance, the company meeting estimates to the exact penny so that the stock can be precisely and comfortably positioned in the portfolio of the major asset managers. Note again the ultimate (and unreachable) locale of this problem ... not (directly at least) in how CEOs get paid, and how much, but in the first instance in how (and how much) the asset managers, the people who buy the CEO’s stock, get paid. In financial services, the only real money these days is in asset management, not commercial or investment banking or brokerage; asset managers are graded quarter-by-quarter, which filters down to the people who control the firms in which they invest.

- Given the natural propensity of CEOs to please the people who own their companies (the institutional asset managers), there is a large incentive to hit the number, even if you have to cook the books a bit to do it. For genuine efforts at reform to succeed, the trick, obviously, is to create counter-incentives, to lift the typical CEO’s horizon towards the long term, despite pressure from the analysts and institutional managers.

- One virtue of lengthening the reward horizon is that creative accounting usually has a short shelf life; sooner or later, someone rings an alarm bell ... maybe even the SEC.

- The two “solutions” currently advertised most prominently do not work. Thus, requiring the CEO *et al.* to hold the option stock for a year post-exercise, at least in today’s volatile market, is an invitation to personal ruin. In the first, place, where does the CEO get the money to exercise? Under the

Sarbanes-Oxley Act, the CEO can no longer borrow from the company. Let's say she borrows on margin. The problem is, if you put a CEO in that position (having paid the exercise price, with the option out of the money a year later) just watch her really push the envelope in order to goose the stock price. Moreover, the idea to issue stock versus options, advanced recently by some commentators who feel options distort incentives, does not work for these reasons. If the stock is a gift, the company must "gross up" in order to pay tax (plus tax on the gross up) on the trade ... an inefficient use of capital. And, the traditional fix for this problem, a company loan, is now a crime under Sarbanes-Oxley.

Against this background, please consider the following proposal ... a fix which I submit: (i) does not require much government action (except a bit of comfort from the IRS); (ii) preserves fundamental benefits of option plans; (iii) is cash flow positive for the Treasury; (iv) opens up the opportunity of a totemic sacrifice, meaning companies can substitute the new regime for the option plan so as to purge themselves of the evil spirits everywhere lurking; (v) lengthens time horizons; and (vi) fixes some secondary problems in the bargain.

DISCUSSION

The critics are, as am I, flabbergasted at the inflation in CEO compensation over the past decade ... \$10 million a year is small potatoes for some executives. Think, in fact, \$100 million a year, a fair amount in actual cash but principally driven by option awards. The seeming overpayments, particularly against the backdrop of company failure, has called into question the entire system of option compensation. If the CEOs made out like bandits and the little people lost their jobs and their savings, the system must be wrong. All aspects of option plans are now under fire ... how they are accounted for, taxed, sized, awarded, etc.

How We Got There

First, why has so much been paid to CEOs, CFOs *et al* during the past decade? Lush stock options, huge bonuses, limitless loans went well beyond historical norms. The principal answer stems from relentless commitment, I think, to the pay-for-performance mantra, which was all the rage in the 80s, repeatedly chanted by critics (whom the liberal press applauded as tribunes of the people) of what was then perceived to be entrenched, sedentary and risk averse managers. Much of that criticism was self serving, propaganda by wolves in sheep's clothing ... *i.e.*, the corporate raiders pretending to defend the moral high ground in aid of their pet greenmail and hostile takeover initiatives. But the notion stuck ... tie the managers' pay to the shareholders' outcomes. If the company remains stodgy, its stock performance less than outstanding, fire the senior management, replace the same with entrepreneurs (or predators, if you like, to borrow Jim Stewart's label). The SEC, indeed, put its official imprimatur on the movement; ironically the very option schemes which are now reviled were heralded as the solution, the way to a solid future for Corporate America in the '80's, the delight of the very 'reformers' who are in the vanguard of today's necktie parties. As a

consequence, I suggest, the board's view of the ideal CEO has changed, often morphing a board's perception of the CEO to the equivalent of an asset manager, and in particular the manager of a private equity fund. I suggest the critics (the managers of LBO funds engaged in hostile takeovers) and the criticized [CEOs] began in terms of image and internal dynamics, to merge ... to look, act and be regarded alike, a common phenomenon in social relations case studies; just as cops and robbers (husbands and wives, people and their dogs) tend to take on common characteristics because of their continually being in each other's company. Hence, the raiders (*i.e.*, the general partners of LBO funds who were doing all the talking during the heyday of private equity investing) and their victims (*i.e.*, the managers of the target companies) began to resemble identical twins. Please recall Abe Lincoln's story about the two gents who wrestled with each other so long, they wound up in the other's overcoat. If Harold Simmons, Boone Pickens, Carl Ichan *et al.*, preached that Corporate America needed to be shook up, the CEOs to look and act like Simmons, Pickens and Ichan, the logical extension of that thesis is as follows: since Ichan, *et al.* normally took a 20% carried interest in the profits earned on their investors' capital, why shouldn't an outstanding CEO be paid in like vein?

The logic had, in fact, enormous surface appeal, as per the following scenario:

- Ichan, on behalf of KKR, criticizes management and seeks to take over Company X; the current team is too timid, too paranoid, too concerned about a regular paycheck vs. shareholder value;
- Ichan takes control of Company X in order to unlock shareholder value, buying 50% of the stock, and installs Superhero as CEO;
- Superhero cuts costs, boosts profits and Company X's market cap goes from \$1 billion to \$3 billion in a year's time. Ichan makes \$300 million (20% of \$2 billion x 50%). What should Superhero and his team make? Well, how about \$150 million, a modest share of the new wealth created; the larger the company, the larger the award.

I further suggest this theme proved to be catching. As the market boomed in the '90s, management boomed along with it. If the stock prices tripled on Superhero's watch, why shouldn't she get what amounts to a percentage deal ... a carried interest in the appreciation in market cap? The directors were influenced by the fact that (a) good managers were and are scarce (and they are); and (b) everyone was making out ... particularly (on paper) the very shareholders Boone Pickens said he cared so much about.

The huge awards, part stock (including options) and part cash, were not noteworthy as long as the music kept playing. The asset managers became super rich but only because they "deserved" to ... their pay was tied to profits.⁴ And so with the

⁴ Pete Peterson likes to denigrate the *amour propre* of the managers of the '80s LBO funds, boasting of the double digit IRRs they delivered to their LPs, by pointing out that, if the Man From Mars

CEOs, whether installed by Ichan or just mimicking his nominees ... pay tied to profits, perfectly aligned with investors, whether the public shareholder or the limited partners of the LBO fund.

The problem, of course, is obvious. The music stopped. Superhero became an ordinary mortal as her company share price stumbled, either because the company had special problems in continuing double digit growth (as almost all do) and/or was caught in the general downdraft. In some cases, Superhero was fired ... but with a generous severance award, negotiated where the music was at its loudest. In others, the annual awards were cut back, but were still pretty rich in view of the lofty heights from which the cut backs were calculated ... a 90% cut in pay is not so punitive if the beginning point is \$50,000,000.

And so now, at last, we get to the real problem. The CEOs, during the boom years, were analogized to the managers of private equity, and paid accordingly, but the analogy was not extended to its logical conclusion. The CEOs were and are paid like hedge fund managers, not the general partners of venture and buyout funds ... a critical error. The hedge fund partners manage, by and large, public equities. They enjoy a big interest in profits, which they take annually and do not give back ... but their investors are relatively liquid because the fund itself is usually liquid (to a point). If the fund does not perform, the investors depart. Ken Lipper is the most recent example of a hedge fund manager with not much left to hedge.

The CEO, on the other hand, is best analogized, if at all, to the managers of a private equity fund whose investors are stuck over a long term ... *i.e.*, venture or buyout. By and large, the LPs in such funds are mired in place. To be sure, the individual shareholders of the public company Superhero is managing can sell; but the shareholders as a group, particularly the large institutions with unwieldy blocks, are stuck, like the LPs of a venture fund.

And, thereby hangs the tale ... or, to put the same in context, thereby appears the solution. If CEO, our Superhero, is to be paid like a venture or buyout general partner (*i.e.* her pay a carried interest in the "profit," measured by increases in market cap), then he should be burdened with the customary protective provision ... the so-called 'clawback.'

In venture and buyout funds, the clawback operates to true up allocations and distributions of profits over the ten to twelve year life of the fund. If the general partner pockets big money because of extraordinary profits early on, and those early achievements are not sustainable, she owes hard cash back to his investors at the end of the day, when the fund liquidates. If it turns out the fund wound up making no money at all, then she has to give it all back.

Why not, in short, apply the clawback to Superhero, the CEO of Company X? The logic is that the CEO is, first, hired to obtain long term results, likened, say, to

could have leveraged the S&P index by 80% (vs. 50%) during that period, he would have delivered a compounded 35% IRR.

Henry Kravis.⁵ She gets modest base pay annually, and a carry ... again like Kravis. Finally, her carried interest in profits (net of what she needs to pay taxes) is escrowed until the end of the day (and why not ten years?)⁶, when the hits, runs and errors during her stewardship are calculated and her pay true'd up, again like Kravis'. After true up, her escrow account may be a big number, or it may be zero.

The point is that, since the boards have bought into only half the 'fund manager' analogy, today's CEOs have it "heads I win, tails you lose." In good years, they take home big numbers; in bad years (like hedge fund managers), they do not give anything back. Who wouldn't be tempted to try an accounting trick or two, or plunge into a glamorous but unwise merger under those circumstances?

In short, if we were to measure long term performance (and, if the analogy is extended as it should have been, for once we would really mean it), the CEO obtains no advantage (or almost none) by loading up in a particular quarter. She can exercise her options and sell into a temporary rally; but the 'true up' means she will have to give it all back when and if the market takes its revenge.

THE FIX

Replace Stock Option Plans? With What?

Some wag once said (Mencken, I believe) that all difficult problems have solutions which are both simple and wrong. The test of the foregoing analysis, assuming it survives as a plausible hypothesis, comes when the board of a public (or, indeed, a private) company attempts to implement the same. Can the present system in fact be improved on in the above-mentioned critical detail, and perhaps a number of others as well? The proof of the pudding, they say, is in the eating.

The seemingly simplest way to achieve "reform" is, as many of the loudest voices would have it, to junk stock option compensation entirely and shift to a bonus plan or, if you want to dress up a bonus plan and make it look equity-flavored, a phantom stock plan. However, there are obvious problems with a straight bonus plan (and I will leave aside the accounting issues for the moment). If the management team is entitled to, say, a share of the upside (as measured by increases in market capitalization) which approach stock option levels (say, 15%, plus or minus, of total outstanding shares), then the cash drain on the company could be out of sight. Let's say the compensation committee eliminates the entire stock option plan and substitutes a phantom stock plan. In our hypothetical case, the company stock price surges from

⁵ Although all coincidences are viewed with suspicion in today's cynical environment, in fact my conclusions were arrived at independently and not borrowed from a strikingly similar analysis (antedating mine) which appear in a paper authored by Harvard Business School Professor Brian J. Hall, *Incentive Strategy: Executive Compensation and Ownership Structure* (Part II) 4 (May, 2002) (herein cited as "Hall").

⁶ A Booz Allen study, coincidentally, puts the average term of a U.S. CEO at 9.5 years, a number which appears to be shortening as CEOs come under increasingly intense pressure.

\$1 billion to \$3 billion, based on the promise of a couple of break through oncology therapeutics; but the company still does not have much in the way of cash flow. How do you pay out \$300 million in cash to the executive team (15% of \$2 billion) without breaking the bank? Currently, the only way to achieve that result (by and large) is with options. The cash representing the executive's profit share comes not from the company (which doesn't have it) but the stock market. (Note that the solution outlined herein does not mean a retreat to fainthearted CEO compensation; the working assumption is that the essence of the '80s analogy should be preserved ... but radically improved. While the cascading criticism of options is so intense and pervasive, albeit often unfair and typically uninformed,⁷ that a search for a replacement solution is in order, nonetheless, we do not want to throw the baby out with the bath water, I submit; we need to offer extraordinary compensation to extraordinary CEOs and, not revert to the European model. In the right circumstances, the opportunity for 'venture capital' type rewards is what generates an aptitude for constructive risk on management's part and, in the process, helps create great companies.

The second, and equally necessary, element of option grants is that the tax paid by the recipient is postponed until realization ... until there is cash with which to pay the tax. With rare exceptions, options are not taxed as of the date of grant; the tax is not due until exercise (in the case of non-quals, exercise being usually accompanied by sale) or sale of the option stock in the case of ISOs. Stock grants lack that quality.

The keys, in short, to the underlying, and constructive, economics of option plans have little or nothing to do with accounting legerdemain or tax avoidance; they are (i) the ability to pay percentage of "profits" compensation; (ii) the necessary cash requisitioned from the market, not the company; and (iii) tax paid only when and if the cash is available with which to pay it.

Having concluded that stock options are a continual source of contention, I repeat the question: Can the entire concept be replaced with a new, improved version which preserves the economics mentioned above? Can companies bent on compensating desirable executives with equity simply junk the stock option plan, thereby eliminating the difficulties which are inherent in dealing with accounting for derivative securities, which are by their nature complex and entail hard-to-quantify impacts on a company's financial statements?

Let's say we eliminate the structure entirely. That done, we still need to face up to the cash flow problem. We need to continue to tie executive compensation to performance, and to reward the 'best in breed' executives competitively. Cash from the

⁷ For example, the charge that stock options involve sham accounting is simplistic. The dilutive effect of stock options are, in fact, accounted for in the all - important earnings per share number; in-the-money options are treated as outstanding for purposes of that calculation. On the tax issue, since today's executives either obtain non-qualified options initially or turn their incentive stock options into non-qualified options, the tax effect is neutral; the company gets a deduction because, and only because, the executive pays tax on the spread. If the company didn't get a deduction, then simple rules of tax equity require that the executive will be relieved of her tax burden. In either case, as far as the Treasury is concerned, it's a wash.

company's resources is not the answer, not at the levels we are talking about. Restricted stock awards and other equity flavored solutions lack one or more of the three key advantages discussed earlier, usually the tax postponement feature.

THE NEW CONCEPT

Rather than escrowing, in effect, say, 20% of the company's outstanding stock into a stock option pool, the "fix" I am suggesting contemplates issuing outright 20% of the outstanding stock into a private equity fund, organized as a limited liability company (the "LLC"). The question of accounting for dilution is, as of the date of issuance of the shares, settled. The shares are currently outstanding; they have been issued to a limited liability company (taxed as a partnership) of which the company is initially the sole member, with an opening capital account equivalent to the then fair market value of the shares so deposited. The managers of the LLC are the compensation committee of the company's board. The members (other than the company) are the executives who otherwise would have participated in the stock option pool. They each are issued profits interests which can be adjusted annually or periodically by the managers without the imposition of tax (as long as capital accounts are not shifted). New executives join the pool, others withdraw and the assets are "booked up" annually so as to start all newcomers on a level playing field, so to speak, with the existing employee members. Each executive will be required to contribute sufficient cash to the pool to qualify as a true "partner" for tax purposes, a reasonable burden usually pegged at 1% of the 'value' of the fair market value of the shares. (This is one of the tricky parts; if this solution has traction, I assume a relevant Revenue Ruling can issue to bless the arrangements we are describing, so as to take any tax suspense out of the equation.)

Each member has a special profits interest, representing an interest in a fixed number of shares, and if she dies, becomes disabled or her employment terminates, the LLC sells the shares into the stock market and distributes the profit, meaning price minus tax basis as marked to market, and minus any contractual give backs ... if the CEO quits and joins a competitor, for example. The shares may be distributed (tax free) earlier, in whole or in part on petition of the executive and agreement of the managers (death, disability, discharge other than for cause, pressing need), and presumptively will be distributed upon a change of control (subject to negotiated vesting restrictions), provided that, in the CEO's case, shares of the acquirer may be held in her capital account to see if the merger works as the CEO advertised it. The company's profits interest is, in effect, the reservoir; as awards are made and/or lapse each year, the company's interest is enlarged or diminished. The compensation committee may elect to sell shares in lieu of distributions in kind and distribute proceeds, depending on market conditions and legal considerations. The shares in the account may be subject to a buy/sell arrangement if the parties so agree and, in any event, a right of first refusal in the company is presumed. Distributions to the departing executives are subject to an escrow of, say 50% of the profits to satisfy the clawback requirement. That means that the executive takes (depending on the provisions of her employment contract) half the realized profits, pays tax at capital gains rates and puts the remainder in her pocket, subject to a clawback calculation which cuts in at the end of ten years. (Note the clawback is a general claim on all the executive's assets, not limited to the escrow.)

Until the expiration of the ten year period, the executive leaves in her capital account escrowed profits in the form of stock, or cash which the managers can use to buy more stock, the capital account standing as collateral for the clawback at the end of the ten year period, when the true up occurs and the departing executive either pays up or not, depending on the fortunes of the company over the period.

Advantages

The advantages of this system include: (i) the fact that it carries the analogy all the way through to its conclusion; the executive is paid like an asset manager ... with not only the benefits but also the burdens, including the clawback; (ii) taxes are paid at capital gains rates (assuming the Treasury and the Internal Revenue Service go along and treat the members as true partners for tax purposes) when, as and if cash is realized; in fact, the gains tax can be further reduced under I.R.C. § § 1045 and 1202 if the executive joined the plan while the company was still a Qualified Small Business; (iii) there is no advantage to an executive attempting to play the quarter by quarter game; the clawback *cum* true up means that the profits are not finally vested in their entirety in the executive until the tenth anniversary of her initial participation; (iv) the company spends no money for this element of executive compensation; the cash reward at the end of the day comes from the stock market itself; (v) there is no question about hidden dilution; dilution occurs outright, as the shares are deposited in the plan and are, outstanding for all purposes ... including the all important earnings-per-share calculation; (vi) since the company gets no deduction on the sale of the shares and the executive pays a capital gains tax, from the Treasury's point of view this produces more tax revenue than a system which entails a 100% deduction to the company and a 100% tax payment by the executive, personal and corporate ordinary income rates being close to equal; (vii) the management of the entire plan is in the hands of the independent board members *qua* compensation committee and, since the tax code provisions governing partnerships are more flexible, the committee's power to adjust its decisions to current circumstances is enhanced; (viii) no chance of "inside information" temptation to the executive; (ix) no § 16(b) problems and no reason for the company to loan cash to the executive ... the 1% can and should come out of her pocket; (x) there is no need to re-price options; if the stock tanks, the executive has a loss (up to her cash contribution) in her account, which will be included in the true up calculation on the tenth anniversary; she balances that loss against gains in the account by reason of awards in past or future years.

To illustrate the new system, consider the following:

A Case Study

Early in Newco Inc.'s existence, when the CEO is hired, Newco deposits 20% of its outstanding shares (8,000,000 shares) into an LLC. The FMV is \$1.00/share (last round price). Newco owns 80% of the LLC's profits interest and 100% of the capital accounts. CEO pays \$1,000, being 1% of \$100,000 (100,000 shares x \$1.00) to LLC and receives a special profits interest in a separate account representing 100,000 shares.

On January 1 of the next 3 years, the fair market value of Newco stock is \$2, \$3 and \$4/share respectively. CEO is awarded another 100,000 shares on each such occasion; she contributes \$2,000, \$3,000 and \$4,000 to Newco's capital *seriatim*. In year 4, Newco goes public at \$10 share. The stock shoots up to \$30 per share shortly thereafter.

In year 8, CEO resigns and asks to cash out her interest. The stock has settled down to \$10. The LLC distributes 400,000 shares which she sells for \$4,000,000, representing a capital gain of \$3,990,000. The company, at that price, elects not to exercise its first refusal right.

By year 10, Newco is in trouble (or the market itself has tanked). The stock is selling for \$2.00 per share. The true up is exercised, as follows:

The CEO's after tax profit: \$2,793,000 (\$3,990,000 minus 30% assumed tax of \$1,197,000).

For true up purposes, the CEO's notional net profit over the 10 year period is \$100,000 (the shares in account #1, and only those shares, have appreciated ... \$1 to \$2.)

True Up calculation: Credit given for her \$10,000 cash contribution and \$100,000 net notional 10 year profit, for a total of \$110,000. After tax profit of \$2,793,000 minus \$110,000 equals a give back by the CEO of \$2,683,000.

CONCLUSION

Why is the above change in compensation methodology, a change which smacks of a technically-driven tweak, superior to those current proposals in Congress and trumpeted in the newspapers? We are facing a crisis, why does not the crisis call for dramatic remedies, i.e. "throw them all in jail." Let me recite the reasons I think the suggestion outlined above trumps the far more theatrical so-called "solutions" currently on the table.

Thus, the current emphasis on increased penalties(, 'lock em up and throw away the key') ignores elementary psychology. A significant number of the individuals involved are unlikely to be deterred by increasing the punishments facing wrongdoers because they don't believe (and it may turn out that they are right, when all is said and done) that they did anything wrong. To be sure, some number of the offending CEOs/CFOs are aware they are over the edge but nonetheless think they can get away with it . . . or thought so, anyway. For that cohort, simply increasing the penalties

doesn't do much good either. For those who are genuinely convinced they can get away with it, the penalties are irrelevant. For those who acknowledge the risk, the difference between a ten year and a five year sentence is trivial; in either event, the individual has been ruined. The idea of playing super cop in a situation like this may be appealing to one's sense of machismo; but, in reality, the likelihood of that approach inducing a significant change in behavior is remote.

So also with the change from the Financial Accounting Standards Board to an entity composed of government appointees. The expertise of the nominees is unlikely to improve because the FASB representatives are eminently well qualified senior members from within the profession. It is true that, on the issue of expensing stock options, FASB was compelled to cave to political pressure and the Board rescinded mandatory expensing; I happen to think the result was right but the fact that the politicians won the day through pressure tactics is lamentable. The question before the house, however, is whether a board composed of government appointees will be less sensitive to political pressure than an independent, self-regulatory organization. If you believe that, as they say, I have a bridge over the East River I would like to sell you.

Further to idea of imposing sanctions, I challenge the common sense of the rule compelling separation of the audit and consulting functions, as in the public interest. The idea is that accountants hired by a public company as consultants will admire the revenues from that assignment so enthusiastically that they will roll over and play dead with their audit hats on, in order to hold on to the combined business. There may be something in this; but the solution has no apparent logic. Once the consulting function is stripped out of the major (and indeed minor) accounting firms, then it becomes harder for the members of those firms to make the same compensation they have become accustomed to. In order to hold on to existing customers, and to attract new ones, why wouldn't the temptation (with the wolf at the door, so to speak) to bend the rules be even stronger, rather than milder, amongst the individuals whose judgments are the only judgments that count in this equation.

Similarly, the requirement that each public company board be dominated, at least numerically, by independent directors is a "reform" without much in the way of new teeth. The independent directors are well represented on the boards of most companies today, and in fact already control the key committees ... nomination, audit and compensation. The fact is that companies are run by their managements. If the company is in fact being managed by a board of directors, it is usually a train wreck on the way to happening. There is only so much a board of directors can do in preventing a management chicanery; it is not at all clear simply how adding more directors the equation will have much impact on the ultimate results.

The ultimate cop out is the idea that the financial statements will be sanitized if we insist that individuals in effect warrant them, the risk of a breach of warranty (viewed in hindsight, of course) being a jail sentence. This smacks, of course, of *per se* liability, the presumption of guilt in effect and is unlikely to survive judicial and fundamental scrutiny, given our constitutional notion that criminal penalties are applied only in the presence of so-called *mens rea* ... intent or recklessness that borders on

intent. Moreover, the requirement can be defanged by careful attention to procedural details. Counselors are already in the arena (i) challenging the constitutionality of what is ultimately the essence of the politicians' cop out; and (ii) constructing systems whereby the risk of error is disseminated widely enough so that no one individual is guilty. If a CEO is asked in effect to warrant financial disclosure, then that individual (assuming he or she is well advised) will lay down a paper trail which rebuts entirely the idea of an intent crime. First the individual reads the financial statement from start to finish; the fact that the statements may not mean anything to that individual is irrelevant . . . she has read them. Secondly, the inferior personnel in the company will be asked, individually and collectively, to provide written comfort that each and every item is appropriately accounted for. If there is any doubt in anybody's mind on a particular issue, then an outside consultant will be brought in and paid to express an opinion. That opinion is likely to be a so-called 'reasoned' opinion, which means that it contains a sufficient number of assumptions and qualifications that the maker of the opinion cannot be prosecuted . . . or, indeed, successfully sued. As I tell clients from time to time, I can sit in my office on a Tuesday and give a reasoned opinion (assuming I am in control of the qualifications) that the day of the week is actually Thursday. Once there have been enough people looking over the other guy's shoulder, sufficient memoranda, comfort letters, reviews, *et al.*, then the chance of a CEO/CFO, even one bent on cheating, stubbing her toe becomes infinitesimal.

The short of the matter is that reform in this space should focus on the 'carrot' rather than the 'stick'. What is it that drives management today, and how do we adjust the process so that the key managers behave themselves? In the 80s, the notion was that the ultimate reward was lifetime employment at a steady salary . . . job security, in other words. The reformers felt that the parochial, turf-conscious, self protective instincts of management in the 70s and 80s were holding back the growth of Corporate America . . . and, I think they were right. Risk aversion can become epidemic in a large organization and ultimately stifle it. While Dick Foster and Sarah Kaplan used one very wrong example in their book, *Creative Destruction* (Enron), their fundamental thesis was right: The S&P over a twenty year span loses about 90% of its membership. For companies to survive in today's global economy, the fundamental imperative is: "innovate or die." This necessarily requires a management which is, in very important respects, the opposite of risk averse, which entertains a healthy appetite for taking calculated risks in order to keep the growth curve in line with society's expectations. You cannot ask an individual to take risks if she is paid according to a formula which is essentially static; the two notions are mutually exclusive. Accordingly, pay tied to performance, and generous pay for generous performance, are axioms which we accept as self proven in our economy, a necessary cornerstone of the United States' modern prosperity.

If all the above are more or less right, then the discussion comes down to a simple point. How do you preserve the risk/reward calculus which the reforms of the 80s introduced into our economy, without creating incentives to game the system. If you are able to do that successfully, I submit, you don't have to do much else. Adequate penalties, I argue, are already in place. There are plenty of sections of Title 18, U.S. Code on the books which enable prosecutors to go after criminal behavior; and, if the

behavior is not criminal, then it is not fair to convict ... simply because somebody has to be the villain, this is not the American way. Moreover, scapegoating would not do much good even if it were legal; it never has.

One is necessarily led therefore to the 'carrot' and, such is what this paper and the system it advances are all about ...