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JAMES P. GARLAND
PRESIDENT

May 21, 2002

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

Dear Chairman Herz:

I'm writing to ask the FASB to require that stock options be treated as a compensation expense.

There are always potential conflicts between the interests of agents who run corporations and the investors who own the corporations. Agents want to feather their own nests, while investors want good returns. Options magnify this conflict.

Options are terrific motivators due to their leverage. Suppose XYZ Corporation grants at-the-money options to its executives when its stock is at \$30. The cash-in value of the options is zero when the stock is at \$30. But every single dollar of appreciation puts (typically) hundreds of thousands of dollars in the executives' pockets. Options motivate executives to boost the stock price. But boosting the stock price does nothing for long-term shareholders like us. In fact, these efforts typically work against the interests of long-term shareholders. Here are some examples.

- Hewlett-Packard's executives own millions of options. In FY 2000 they went on a buying frenzy to boost the value of those options. HWP spent over \$5 billion on stock buybacks that year — including \$1.9 billion that it borrowed — and paid an average price of \$57 per share. Today its stock sells for \$19. Did the buybacks benefit HWP executives? Yes. Did the buybacks benefit long term HWP shareholders? No.
- At a board meeting last year Mellon Financial raised its dividend — and awarded stock options to all its directors. At its next board meeting Mellon announced it would cut its dividend in half and use all available cash to buy back stock to boost the stock price. Mellon spent over \$1 billion on stock buybacks last year. Mellon's executives got a reward from these buybacks. Its chairman made a \$6 million profit by cashing in just some of his options. We are Mellon shareholders. What did we get from the buybacks? A slightly

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higher stock price — which is of no value to us whatsoever — and a much lower dividend. Basically, we got taken to the cleaners.

I could tell more stories, but I'm sure you get my point. Options motivate executives to take actions that are often contrary to the interests of their investors. In fact, as we've seen recently, options are such terrific motivators that they even encourage executives to break the law. While options do motivate executives, they don't always motivate them to further their shareholders' interests.

I don't want to abolish stock options, mainly because I'm worried about unanticipated consequences of such an action. After all, the growth in the use of stock options appears to be an unanticipated consequence of the \$1 million cap on compensation that Congress established some years ago. My request is more modest. Please require companies to expense options as they grant them. If options were treated as an expense (which they are), and if options were expensed on the P&L (as they should be), then there would be fewer options. And fewer options would mean fewer conflicts between managements and shareholders.

Standard & Poor's recently established a new standard for corporate earnings for its own research and for indices such as the S&P 500. The new standard expenses employee stock options. Frankly, I'm pleased that Standard & Poor's acted to improve the integrity of the information that it provides to investors. But I'm unhappy that the two regulatory bodies that watch over my interests — i.e., the SEC and the FASB — are dragging their heels in this matter. The overuse and abuse of options is a scandal. While I would have preferred to have seen your agency take the lead in this matter, it's not too late to join the movement. Please require that options be expensed.

Sincerely,

A handwritten signature in black ink, appearing to read "James G. Gandy". The signature is fluid and cursive, with a large initial "J" and a long, sweeping underline.

JPG:s
enclosure