

**Stacey Sutay**

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**Subject:** FW: Request to appear on June 29, 2004 Roundtable on Share-Based Payments

-----Original Message-----

**From:** Calvin Johnson [mailto:chjohnson@mail.law.utexas.edu]

**Sent:** Tuesday, June 08, 2004 5:34 PM

**To:** Len Tatore

**Cc:** Karen Salmansohn

**Subject:** Request to appear on June 29, 2004 Roundtable on Share-Based Payments

On June 1, I sent a tentative position paper, titled "Accrue the Intrinsic Bargain on Compensatory Options Annually as it Arises and Fluctuates," of the Coalition to Stop Stock Options for the June 29, 2004 Norwalk Roundtable on Share-Based Payments. The time for review by our members had not expired, and the heading notation identified the position paper as not quotable yet. It has now been reviewed.

I attach a final copy of our position paper. The changes made are not material.

I embed the summary here, through to the end of the message

Summary of Statement: Compensatory stock options need to be reported by the issuer by accruing the intrinsic value or bargain on the option annually, as the bargain the option would generate by exercise arises and fluctuates. Value when the option is granted is a rough estimate of the issuer's ultimate cost, as determined by the law of averages and past volatility in the price of the underlying stock. But investors want not just a premature estimate, but more importantly what cost the option turns out to have for this issuer. Options that lapse are indeed free for the issuer. Some options are very expensive for the issuer.

Appraisal of value of the option at grant is too hard for many managers to understand. Management is also too intensely self-interested to give unbiased or good faith estimates of value on compensation issues. Auditors also can not be counted on to be adverse to managers on compensation issues that are so critical to management, unless they have bright line rules, which an accrual of the bargain would provide. Management estimates of value, even if audited, need to be trued up to the actual cost when the option is settled.

The standard proposed for plans to be settled in cash is superior to the proposed standard for plans settled with stock because the former mandates accrual of the liability or bargain annually as it arises and fluctuates. There is no practical nor respectable intellectual distinction between plans to be settled in cash and plans to be settled in stock. The standard proposed does a better job when valuation is "virtually impossible" at grant because the standard would then measure the cost annually by measuring the bargain. Since the future is always virtually impossible to ascertain because it has not happened yet, the standard should ordinarily consider valuation of the future outcome to be impossible at grant and rely instead on intrinsic bargain as the future unfolds. The tax accounting standard allows tax reporting of the option at grant ordinarily only when the option is actively traded on an established market. In this *limited* case the tax accounting standard is wiser than the proposed financial accounting standard.

While valuation at grant is not a reliable enough estimate of cost to serve as a standard of reporting, the value of outstanding options is quite useful supplemental information that can help investors cope with the future. Appraised value of *all* outstanding options thus needs to be disclosed in footnotes.

The Coalition to Stop Stock Options also supports FASB's ending of the reporting of compensatory options as if they had zero cost. Zero costing of options is inaccurate, even fraudulent accounting. Stock has a cost because stock issued in response to options diverts future cash from historic shareholders, and indeed the stock and stock options are simply proxies for the discounted present value of the cash that is expected to be distributed by the issuer. Zero costing of options defrauds investors and convinces them to invest in companies that inflate their earnings by ignoring material costs of compensation. When compensation is treated as free, managers bamboozle more compensation out of their shareholders than they otherwise would get. Zero costing also sometimes convinces fiduciaries to be irresponsible in issuing options because the managers truly delude themselves into thinking that the options are free. Ending the fraud in zero costing of options will have *only* salutary effects on the allocation of investment capital, on jobs and on the health of the economy.

Accrue the Intrinsic Bargain on Compensatory Options Annually as it Arises and Fluctuates.

Statement of the Coalition to Stop  
Stock Options,  
FASB Roundtable on Share-Based  
Payments, Norwalk, Connecticut, June  
29, 2004

My name is Calvin Johnson, and I am the Andrews & Kurth Centennial Professor of Law at The University of Texas School of Law in Austin, Texas. I am the current chairman of the Coalition to Stop Stock Options. The coalition is composed of distinguished senior law professors who teach or write in the area of accounting, corporate governance or tax. A list of members is at the end of this statement.

Summary of Statement: Compensatory stock options need to be reported by the issuer by accruing the intrinsic value or bargain on the option annually, as the bargain the option would generate by exercise arises and fluctuates. Value when the option is granted is a rough estimate of the issuer's ultimate cost, as determined by the law of averages and past volatility in the price of the underlying stock. But investors want not just a premature estimate, but more importantly what cost the option turns out to have for this issuer. Options that lapse are indeed free for the issuer. Some options are very expensive for the issuer.

Appraisal of value of the option at grant is too hard for many managers to understand. Management is also too intensely self-interested to give unbiased or good faith estimates of value on compensation issues. Auditors also can not be counted on to be adverse to managers on compensation issues that are so critical to management, unless they have bright line rules, which an accrual of the bargain would provide. Management estimates of value, even if audited, need to be trued up to the actual cost when the option is settled.

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I. Accrue the Bargain Annually as it Arises and Fluctuates.

A. The Proposed *Share-Based Payment* Standard: Measure only at Grant.

The Financial Accounting Standards Board has requested comment on its Exposure Draft of Proposed Statement of Financial Accounting Standards, *Share-Based Payment* (March 1, 2004).<sup>1</sup> *Share-Based Payment* would require a corporate employer to recognize as a cost the estimated value of stock options at the time the employer grants the option to an employee. The estimate of value would take account of the price of the underlying stock and the volatility of the stock that contributes to the option's value. Once the value was estimated at grant, however, the cost of the option would not be remeasured because of subsequent changes in stock price or expected volatility.<sup>2</sup> If, however, it is virtually impossible to measure the fair value of the option when granted, then the proposed standard would require the company to measure the bargain or "intrinsic value" of the option at the end of each period and to measure the final cost according to the bargain or intrinsic value when the option is exercised or satisfied.<sup>3</sup> Nonpublic entities could also wait to measure the bargain as it arose, although valuation of the option when granted is preferred. Accordingly, if a nonpublic employer chooses to value the option only once when granted, the standards would not upset that choice.<sup>4</sup>

B. Accrue the Bargain Instead.

This comment strongly recommends that the final standard require the bargain on a compensatory option to be accrued annually as it arises and fluctuates. "Intrinsic value" is the term historically used to refer to the terrible accounting method of APB Opinion No. 21, under which an option is treated as having zero cost throughout its term if there would be no bargain if the option were exercised when granted. Under that method, managers can get their compensation as having zero cost to the issuer if the option is set up to have an exercise price equal to or less than the fair market value of the stock at grant. The zero cost is never remeasured, even if the option is in fact worth tens of millions of dollars when granted and even if it turns out to require the employer to issue hundreds of millions of dollars of stock at a price very considerably below fair market value.

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<sup>1</sup> Financial Accounting Standards Board, Exposure Draft No. 1102-100, Proposed Statement of Financial Accounting Standards, *Share-Based Payment* (March 31, 2004) [http://www.fasb.org/draft/ed\\_intropg\\_share-based\\_payment.shtml](http://www.fasb.org/draft/ed_intropg_share-based_payment.shtml).

<sup>2</sup> Financial Accounting Standards Board, Exposure Draft No. 1102-100, Proposed Statement of Financial Accounting Standards, *Share-Based Payment* (March 31, 2004). [http://www.fasb.org/draft/ed\\_intropg\\_share-based\\_payment.shtml](http://www.fasb.org/draft/ed_intropg_share-based_payment.shtml).

<sup>3</sup> *Id.*, Appendix A at 21, ¶21.

<sup>4</sup> *Id.* at 20, ¶¶20-20A

*Share-Based Payment*, however, uses “intrinsic value” to refer to a totally different and very fine accounting method under which the bargain between exercise price and value of the stock is re-measured at each reporting date and finally measured when the option is settled. The ultimate cost of the option under the *new* “intrinsic value” method would not be set until the option is exercised or settled. To avoid confusion between the two inconsistent methods, this report refers to the latter, new intrinsic-value method of re-measurement for each period as “accruing the bargain” annually.

“Accruing the bargain” does not necessarily mean that there is any *current* expense. The cost will sometimes be debited to a deferred expense account. Under the full absorption method of inventorying, for example, the debit might ultimately be closed, e.g. to work in progress inventory. Since the purpose of incentive compensation that is contingent on stock price, however, is to get the employee to boost stock price, allocating the cost of the option to the period in which the employee succeeds in getting the stock price to increase by expensing the bargain as it arises is a natural and attractive method for determining the appropriate period allocation.

“Accruing the bargain” also means that there will be credit, contra to the expense or the asset if the bargain drops. For example, assume a four-year option to purchase stock with an exercise price of \$100, which is in excess of the price of the underlying stock when the option is granted. Assume the stock rises in price to \$130 at the end of year one after the grant and to \$150 at the end of year two after the grant. The cost or debit to compensatory expense or deferred expense would be \$30 at the end of year one, and \$20 at the end of year two. If the employee exercised the option at the end of year two when the fair market value of the stock was still \$150, there would be no further expense debit since all of the cost had been previously accrued. If the employee does not exercise the option, however, and the stock drops to \$110 fair market value at the end of year three, the issuer would credit \$40 to reduce the expenses or asset to which the option cost had been previously posted, so that the cumulative cost would be \$10. This adjustment reflects the fact that incentive plans based on profit or stock price become cheaper to the employer when the profit or stock price goes down. If the stock drops in value to \$95 at the end of year four and the option lapses without exercise, there would be a further \$10 credit to compensatory expense to reflect the fact that the option, as it turned out, was in fact free to the issuer. Accruing the bargain as it arises and fluctuates reflects the true cost to the issuer, as it turns out, under the assumption that paying with stock is the same in economic terms as paying with an equivalent amount of cash.

C. What is Wrong with Reporting Value Only at Grant?

1. Premature reliance on the law of averages.

An option is a contingent asset whose value depends upon the ultimate value of the underlying asset when the option is exercised. Reporting the option's cost when it is granted is premature because the essential contingency – value of the stock the employee will receive – has not yet been resolved. Some options will indeed prove to be free to the issuing company because they expire out of the money. Some options will prove to be very, very expensive to the issuer. Investors need cost figures that distinguish between very expensive or free according to how the story comes out.

Accruing the bargain as it arises more clearly reflects the true cost to the employer than do estimates made at the time the option is granted of what bargain the option will ultimately give to the holder. Stock and stock options both ultimately have value because they are proxies for the cash that the issuer will pay out to the holder of the stock. Issued stock is nothing but a reflection of the discounted present value of the cash that the corporation will divert away from old shareholders and give to this shareholder. Stock options have value only a reflection of the stock value.

The value of an option at grant depends upon the volatility of the underlying asset. An option to buy a bank account (but not interest) for the amount of the deposit at grant has no apparent value because a bank account does not fluctuate in value. As the volatility or risk on the underlying asset increases, however, the value of an option to buy for its value at grant increases. An option is like a right to bet on the horses after the race has been run. The option protects from loss on a losing horse and skims off all the cream on the winning horse. For very high risk stocks, an option to buy for current quoted value has a value approaching the value of the underlying stock. If there were a stock called Cold-Fusion Corporation, for example, which had a one-in-a-million shot of becoming very valuable, the holder of a no-initial-bargain option would be able to grab the value in the rare case the high value comes to fruition. The value of an option with no *initial* bargain would be short of the value of owning the Cold Fusion stock outright by only one-millionth of the current value.<sup>5</sup>

Valuation of an option must rely on the law of averages to ascertain

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<sup>5</sup> Assume a share of Cold Fusion is worth \$10 because that represents a one in million chance of having share with worth of \$10 million, even when discounted back to the present. Executive X is given an option to buy Cold Fusion share for \$10 at any time over the next 10 years by which time the doubts about success will be resolved one way or the other. In 999,999 times out of a million, both the stock and option are worthless. Still X has a one in million chance of making \$10 million less the \$10 exercise:

$$(\$10,000,000 - \$10) / 1,000,000 = \$9.99999$$

which is less than \$10 current fair market value of the stock only by a millionth of \$10, or one-ten thousandths of a penny.

volatility on the underlying asset. Black-Scholes, binomial pricing or indeed any assessment of option value requires a track record to generate volatility measures. But investors want not a law of averages, but rather the results for this company. You can after all drown in a lake that is only 6 inches deep on average. If you cannot swim, you need to know not the average depth of the lake, but the outcome of whether this part of the lake is a muddy half-inch part or the 40-foot deep part. Even if the average sets a fair expectation for what the market price of the option at grant, investors in the company generally need to know the company's costs according to how the costs come out once the big contingency—value of the stock at exercise—has been resolved. Valuation of a compensatory option at grant is premature.

New companies, closely held companies and thin markets do not generate enough information about volatility or do not have enough of a track record to make up-front valuations reliable for the stock options. Restrictions on the sale of the option or the underlying stock affect value but prevent reliance on market value, because the holder does not have ready access to the market. Under the one-time-only method of valuation on grant, errors in valuation are simply unfixable.

The accrual-of-the-bargain method, by contrast, is feasible for a broad range of new and smaller corporations that do not have a track record of volatility because it is possible to estimate stock price at the end of each year. Under the accrual-of-the-bargain method, moreover, the debit for any year is smaller and the errors are less critical. Any errors under the accrual of the bargain method will be corrected by a new estimate next year, and the cost to the issuer will ultimately be trued up to the bargain the option in fact produces if exercised.

Some managers and investors apparently can not understand option valuation because it depends upon the volatility or risk on the underlying stock. For example, option valuation is apparently over the head of a plausibly sophisticated columnist for the Wall Street Journal:

[The expensing proposal] involves applying an esoteric mathematical operation to executive's stock option at the moment they are granted (i.e., before anyone knows whether they will be worth anything), for the sole purpose of whipping up a dubiously meaningful dollar figure that can be deducted from earnings as the 'cost' of the options.<sup>6</sup>

Accruing the bargain as it arises does not require a volatility measure and thus would avoid a major source of confusing "estoric mathematics"

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<sup>6</sup> Holman Jenkins, Jr., *Much Ado About Stock Options—The Epilogue*, WALL ST. J., April 23, 2003 at A23.

that sophisticated opponents of fair accounting are using to beat FASB once again.

Management is too intensely self-interested in reporting of its own compensation to give unbiased estimates of value. It is not just that option value is too hard for some managers to understand, which is true, but also that managers will be trying to misjudge value to understate the cost of their own compensation. If compensation costs can be understated, then management can tease more compensation out of their company, off-budget and out of sight. In esoteric areas where valuation is not transparent to investors, managers will hire experts to help them understate value. They will design option packages that exploit tiny cracks in valuation into gaping chasms, in order that their compensation will appear less costly. Enron and World Com have unfortunately also taught us that auditors regrettably can not be counted on to be adverse to management without bright-line cookbook rules. Management estimates of value, even if audited, need to be trued up every year to the real bargain, and they need to be trued up to the final actual cost when the option is exercised.

## 2. Market Price of Options Misdetermines the Value for Executives with Control.

Black-Scholes and binomial valuation are designed for arm's-length investors who have no control over the company and when the option holder controls the destiny of the company, the arm's length value can misstate the company's true cost. For a CEO and top management team that really can change the value of stock more than the market expected at grant, the arm's length assumption understates the value of the compensation package the management has received. The stock option is a platform that superior management can turn into gold in ways in which the Black-Scholes option pricing formula can not pick up in advance. What is gold for the recipient is a cost to the payer, so that the cost of superior management will in fact be higher for a company than arm's-length option pricing can capture. Conversely, a management that performs under market expectations or damages the company will be cheaper for the employer than Black-Scholes or binomial pricing has stated because the stock options will not be all that valuable after all. The cost differences between the high-cost, surprisingly superior management and the low-cost surprisingly inferior management will not be picked up by any arm's length valuation method done before the management performs. Investors need financial statements reporting the cost of the incentive package for *this* management and not just reports of market speculations of what the incentive package might cost.

Option value also depends upon volatility of the underlying stock and management can easily affect volatility *after* the grant date. Assume, for example, that an old-line manufacturing company in a mature industry like

glass works has stock with minimal volatility.<sup>7</sup> New management comes in and is given stock options. Assume, finally, that new management then decides to enhance the value of its options by raising the risk of the company's capital investments. Assume that company assets are reinvested in high-risk high-tech endeavors, like fiber optics. The options are more valuable under the high-risk endeavors than they were under the low-volatility circumstances at the time of the grant. Valuing the stock options only at grant misses the events that affect value after the grant, including risks created by the beneficiaries of the option themselves. At the extreme, one might imagine a management that would take all the corporate assets to Vegas and put them down on 36 red to win, simply because the value of an option goes up as risks go up and because option holders do not participate in losses that shareholders suffer. A recent study found that there is indeed a correlation between management holdings of stock options and volatility of the company. Especially in companies that have low outside monitoring, management creates higher debt-equity ratios and invests more in unproven research and development when they have more stock options.<sup>8</sup> *Share-Based Payments'* decision to prohibit re-measurement when expected volatility changes hides the value that management option holders can extract from the company by increasing the shareholders' risk of loss on their stock.

C. Where FASB gets it Right.

1. No distinction between cash payout and stock payout plans.

If the ultimate payment will be in cash rather than stock, the accounting profession has always gotten the issue right by accruing the added obligation every year. *Share-Based Payments* continues the correct treatment when the payout is in cash. Stock appreciation rights ("SAR"), for instance, match a stock option by giving the executive any increase in value of the stock (but not the loss) over some period, but SAR plans end by paying the executive in cash. Phantom-stock plans also pay cash and track stock price, but phantom stock plans track losses as well as gains because the employee starts with a share-like unit that will decline in value when the underlying stock does. For cash-payout plans such as SARs and phantom-stock, accounting standards require that the employer accrue the liability as

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<sup>7</sup> The hypothetical is based on Corning Glass Works, with variations in the facts, which changed from a traditional glass works firm to fiber optics firm, renamed Corning Inc. Corning stock price went from \$20 a share in 1996 to \$113 a share in September 2000 and then collapsed to \$1.45 in October 2002 as fiber optics became swamped by competing producers. [www.grainmarketresearch.com](http://www.grainmarketresearch.com) (accessed May 1, 2003). No implication is intended that options caused the change in behavior at the real Corning, although that is the implication with respect the hypothetical company in the text.

<sup>8</sup> Nam, J, et al., *The Effect of Managerial Incentives to Bear Risk on Corporate Capital Structure and R&D Investment*, 38 *Financial Review* 77 (2003).

it arises even though it is not yet paid. The accrued liability is measured by the stock price the cash award traces. Increases (or decreases) in the employer's payout obligation are posted annually and tried up to the final payment on the plan.<sup>9</sup>

The distinction *Stock-Based Payment* makes between payout in stock and payout in cash is unprincipled. For example, accounting treats straight stock compensation, that is, a payment of compensation in stock without any prior option as an expenditure equal to the equivalent cash.<sup>10</sup> Fair market value of the stock means the cash equivalent of the stock. Stock and its cash equivalent are equivalents, we can say tautologically. The corporation has the same economic burden whether the compensation is to be satisfied in stock or in cash because both impose the same burden on old shareholders. Indeed we could imagine a single plan could be satisfied either in cash or in stock, perhaps at the option of either the employer or perhaps at the option of the employee, without that making any difference in the economics of the plan.<sup>11</sup> Yet in the end, FASB makes a distinction between cash and stock at to stock option compensation plans and does not accrue the existing bargain if the payout is scheduled to be in stock.<sup>12</sup>

## 2. Virtually impossible.

*Share-Based Compensation* also gets it right when the option is "virtually impossible" to value at grant. The proposed standard would require the company to measure the bargain the option would give if exercised at the end of each period and to measure the final cost of the option when it is settled or satisfied.<sup>13</sup> In truth, the future is always virtually impossible to ascertain. As ordinary life philosopher, Yogi, has said, the future is very hard to predict because it has not happened yet.

## 3. Follow wise tax regulations.

In this limited instance, tax accounting standards for reporting a compensatory option are superior to the proposed financial accounting standard. The binding Treasury Regulations will allow a compensatory option to be taxed to employee at grant alone, only if the option has a "readily ascertainable value" when granted. Ordinarily, the option must be actively traded on established market to have such a readily ascertainable

<sup>9</sup> Financial Accounting Standards Board, Statement 123 ¶25 (1995); FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans (Dec. 1978)

<sup>10</sup> Financial Accounting Standards Board, Statement 123 ¶16, 18. The rule is maintained by the proposed Statement, FASB, *supra* note *Share-Based Payment* Appendix A, at 22 ¶25A.

<sup>11</sup> Financial Accounting Standards Board, Statement 123 ¶39 requires a plan to be treated as a cash plan if the employee has the option of choosing cash or stock payment or if there is a pattern in which the corporation pays in cash.

<sup>12</sup> Financial Accounting Standards Board, Statement 123 ¶39.

<sup>13</sup> *Share-Based Payment*, Appendix A at 21, ¶21.

value.<sup>14</sup> If the option is not actively traded on an established market, there is a whole list of prerequisites to making the grant the tax reporting period.<sup>15</sup> If the option does not have a readily ascertainable value at grant, then the compensatory bargain is measured when the option is exercised. The Treasury Regulations demonstrate appropriate concern about the undervaluations of options – although for tax purposes, the problem of biased or fraudulent undervaluation is a problem of the executive's income, rather than of the employer's cost.

In sum, estimates of the value of compensatory options at the time of grant are not reliable enough to serve as a standard of reporting. The options need to be trued up to the bargain the option gives to the holder at exercise. While the option is outstanding, changes in the bargain need to be reported in every accounting period.

#### D. Footnote Disclosure of All Outstanding Options.

While estimates of valuation at grant are not a reliable enough to serve as a standard of reporting on financial statements, the estimated value of outstanding options is quite useful supplemental information that can help investors cope with the future. Outstanding options reduce the aggregate value of existing stock – there is no other place for option value to come from. Thus existing shareholder's need to know an estimate of how badly the outstanding options will undercut the value of their stock. Appraised value of *all* outstanding options thus needs to be disclosed in footnotes.

#### II. Support for Ending Zero Costing.

The Coalition to Stop Stock Options also supports FASB's ending of the reporting of compensatory options as if they had zero cost. An option has material value if there is risk or volatility on the underlying stock even if there would be no bargain if the option were exercised as soon as it is granted. Zero costing of compensatory options is inaccurate, even fraudulent accounting. Stock issued in response to options diverts future cash from historic shareholders, and indeed the stock and stock options are simply proxies for the discounted present value of the cash that is expected to be distributed by the issuer to the option holder.

Zeroing costing of options defrauds investors and convinces them to invest in companies that inflate their earnings by ignoring material costs of compensation. When compensation is treated as free, managers tease more

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<sup>14</sup> Treasury Regulation §1.83-7(b)(1)(1978).

<sup>15</sup> Treasury Regulation §1.83-7(b)(2) &(3)(1978) require that for the reporting period to be at grant of the option, the option must be transferable by the holder, exercisable immediately and that the underlying stock not have any restriction or condition which has significant effect on value. The holder must also show it is possible to value the option privilege, defined as the right to benefit from any increase in value of the underlying stock without risking any loss of capital.

compensation out of their shareholders than they otherwise would get. Zero costing also sometimes convinces fiduciaries to be irresponsible in issuing options because the managers truly delude themselves into thinking of the options as free. Ending the fraud in zero costing of options will have only salutary effects on the allocation of investment capital, on jobs and on the health of the economy.

Respectfully submitted,  
The Coalition to Stop Stock Options

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