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International Accounting Standards Board
Kimberley Crook
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30 Cannon Street
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Dear Ms. Kimberley Crook,

It was my pleasure to take a look at your Exposure Draft 2 Share-Based Payment. The following are my recommendations from my report "High TechNet Croniism" that appear pertinent to your exposure questions. Also, I've enclosed my comments to recommendations made by an industry trade group known as TechNet. As an analyst of technology companies for a major pension fund I may have some unique insights into this issue. Please include my cover letter and enclosed report as part of the public record.

1. Regarding Question 3, 11 the fair value of goods and services received. Please expense employee stock options using the fair value garnered from the Black-Scholes model. The Black-Scholes is the most elegant, accurate, and proven work-horse of an option pricing valuation model on earth. Yes, this value is determinable in response to Question 7. The options price or fair value is more concrete or determinable than the value of the services rendered – Question 6. Especially the over-value placed on a chief executive officer's time and effort.

2. Please, change the way stock options are taxed. Companies should take a tax deduction on the option expense valuation at the time of the grant, or better yet, the moment of vesting -- not when employees exercise -- generating a corporate capital gains tax credit. In response to Question 4, 13 the point of vesting is when realization is complete, so I think that's the best point to take the operating expense.

3. Stop treating the cash in-flow on employee option exercise tax credit benefit as an operating cash flow.

4. Make derivative transactions on a company's own stock more transparent. Investors should know more about the selling of put options to hedge employee stock option plans. These transactions should be clearly detailed in the 10Q footnotes: strategy, timing, triggering events, and worst case risk scenarios.

5. Bring back the 1991 U.S. SEC rules to restrict the selling of stock by executive management for extended periods of time after exercise or better yet, until they are no longer employed at the company issuing the option grant.

7. Please limit the ability of board members to sell any options they are granted while on the board. When there are supplier or buyer links between a company and its board members there will be conflicts-of-interest. Stock options to these individuals should be prohibited.

8. If companies do grant stock options, then promote equitable distribution of the stock options based on an employee's pay. Companies should publish the distribution of stock option grants by annual salary. Since distributing options to middle-level managers has the greatest impact on shareholder return, shareholders should know how the company distributes stock options among its workforce. I suggest creating buckets of salary ranges and giving the percentage of options granted to each range, quarterly. Middle class, lower class, and professionals

at companies should all participate equitably in stock options, not just executive management. Increasing equity ownership to middle-level managers has a greater impact on corporate performance than top-tier executives.

9. Stop option re-pricing or issuing new options when the company exhibits poor performance for an extended period of time. Set a triggering event, possibly a 30% share price decline. After the trigger hits prohibit new option grants or option repricings for two years or more. Set conditions to preclude options grants when shareholders get burned.

10. Promote indexing options and premium-priced options.

11. Provide accounting incentives for restricted stocks.

15. Provide all stock options in the diluted share count figure, including those with exercise prices below the stock's market price, i.e., the under-water options.

16. In response to Question 14, ban reloads completely and for that matter repricing.

It was my dubious pleasure to review the footnote expensing of stock options proposal from TechNet and AeA. My duties include analyzing and recommending technology investments for our convertible bond portfolio. Other than TechNet's usual specious claims that stock options do not represent an expense, all employees at all levels participate, and the usual bashing of Black-Scholes as a meaningless -- misleading -- inaccurate -- "bad number," it was impressive and magnanimous of them to voluntarily agree to present the same repackaged information on a quarterly basis. Also, I'm always impressed by their wide use of adjectives to lambaste the Black-Scholes Model. Essentially, TechNet's proposal consolidates data already available in the 10Ks and Proxies, making it timely. I didn't notice them disclosing anything new or not previously available. The following are my thoughts and critique.

1. The expensing of stock options should be mandatory and expensed using the Black-Scholes options pricing model, similar to any other form of compensation. Also, the above-water and under-water options should be included in the expense -- all options – regardless of the relationship between exercise and market price. The expense should be a deduction to operating income in the income statement, anything less is not accounting reform and will not accurately represent a firm's profitability.
2. Out of 3000 members only 33 agree to voluntarily supply the quarterly data. Today, even when mandatory, I find company's leave out required financial information in their SEC filings. Then you must call them and ferret it out. On occasion, I've had to threaten companies by reading the actual SEC regulation and item number. Please, I request that expensing of options be made mandatory. One standard format is wonderful, but everyone must participate. The only way everyone participates on a level playing-field is to make it mandatory.
3. We need more information than option grant amounts provided to the top-5 executives. It would improve our evaluation of an organization to have the option grant distribution segmented by salary level. According to the Rutger's Blasi and Kruse study the less options going to the top-5 and more going to mid-level operations managers improves performance below a mean of 19%. In other words, provide us a table with buckets showing how much each salary class received in options. Why should the industry disagree with this, they always claim the rank-and-file participate? Unfortunately, the rank-and-file don't participate, so they won't agree. I know, because I worked in the technology industry.
4. The proposal refers to the "dollar value" of the option. If this refers to intrinsic value then the number is meaningless. For proper evaluation it must be a true option value, i.e., calculated with the Black-Scholes or Binomial method. Note, I find the Black-Scholes to usually under-state the option's true market value, so the industry should embrace Black-Scholes. From my experience trading options, Black-Scholes displays amazing accuracy, reliability, and is a proven work-horse of a methodology. If they don't like the Black-Scholes value have the brokerage firms or investment bankers bid on a price for them.
5. As an analyst, I need to know the details on any option hedging strategy or how much it costs to purchase the shares for the options exercise. Over the last 5 year, on average, companies have paid out roughly five times more than the amount that they receive from the proceeds of those exercising options. The cost of maintaining an employee stock option program is exorbitant and strongly impacts the financial health of an organization. If puts are sold hedging the stock exposure, I'd like to know the size of the hedge (units – puts – forward

contracts), type, expiration, cost – proceeds, triggering events, and with whom (counter-party brokerage). From experience, I've been burnt a few times when that 10+ sigma event occurs and the hedge's loss becomes material.

The enclosed report describes how TechNet persuaded a distinguished board not to support the expensing of stock options. There is no excuse for supporting the siphoning off of investors' wealth to senior Silicon Valley executives. You have to question political appointees as pension fund board members, there are untold conflicts-of-interest.

The following report looks at 10 technology companies. All 10 have abused the use of employee stock options and lost shareholders on average 93% of their value from the 2000 stock bubble's peak. Please continue your efforts at accounting reform and return accounting to a legitimate profession. Teddy Roosevelt exemplifies the pretext for the loyal oppostion, "To announce that there must be no criticism of the President – or that we are to stand by the President right or wrong is not only unpatriotic and servile, but is morally treasonable to the American Public." Let me know if there is any way I can assist your accounting reform efforts.

Sincerely,

Andrew H. Dral

High TechNet Croniism

by

Andrew H. Dral
January 14, 2002

It is not the critic who counts; not the man who points out how the strong man stumbles, or where the doer of deeds could have done better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood; who strives valiantly; who errs, and comes short again and again, because there is no effort without error and shortcoming; but who does actually strive to do the deeds; who knows the great enthusiasms, the great devotions; who spends himself in a worthy cause; who at the best knows in the end the triumph of high achievement, and who at the worst, if he fails, at least fails while daring greatly, so that his place will never be with those cold and timid soles who know not victory or defeat.

To announce that there must be no criticism of the President – or that we are to stand by the President right or wrong – is not only unpatriotic and servile, but is morally treasonable to the American Public.

We draw the line against misconduct, not against wealth. The capitalist who, alone or in conjunction with his fellows, performs some great industrial feat by which he wins money is a well-doer, not a wrong doer, provided he works in the proper and legitimate lines.

Teddy Roosevelt

<u>This report is not endorsed or authorized by the California Public Employees' Retirement System (CalPERS), its author is responsible for its accuracy and contents.</u>

High TechNet Croniism

Executive Summary

Introduction
The California Public Employees' Retirement System (CalPERS) board decided not to endorse the expensing of stock options – voting unanimously. By not embracing the expensing of stock options they tell me CalPERS' board did not breach its fiduciary duty to plan participants and their benificiaries. If this wasn't a breach of fiduciary duty to exercise care and loyalty then what is? At best, the board conveniently skirted the issue, so as not to antagonize key consitituents; at worst, it neglected its duty and compromised itself to the special interests of TechNet, i.e., high tek chief executive officers (CEOs), venture capitalists (VCs), and other stakeholder friends whose interests deviate from investors. One member of CalPERS' board, Phil Angelides, does not believe in the expensing of stock options: "this is not an expense, this is an equity transfer." Mr. Angelides does not represent the best interests of his 1.3 million pension plan constituents or 94 million shareholders who trust CalPERS to be their voice. It's no coincidence that the ten option heavy technology companies I studied lost shareholders, on average, 93% of their value from the 2000 stock bubble's peak. CalPERS' neutral position on the expensing of stock options is particularly disturbing when considering TIAA-CREF's position and the Council of Institutional Investors.

The Effects of Stock Options on Earnings Per Share (EPS)
The use of employee stock options by technology companies is out of control by both the wanton distortion in earnings and dilution of shareholder value. *Business Week* cites options as currently accounting for 80% of executive compensation. The missing cost of options gets greater and greater every year, and more perverse. Exempting the expensing of options inflated S&P 500 earnings by 31% in 2001, over a three fold change over 2000's 9%. Moody's took a different cut at the data, according to annual reports, expensing of stock options would have reduced the aggregate net income of the S&P 100 by 5%, 7%, and 16% from 1999 through 2001.[9] During the twelve months prior to June 30, 2002, S&P reported stock options overstated earnings of the S&P 500 by 19.5% or $5.21, out of $26.74 earned. Information Technology (IT) companies were responsible for 48.4% of the options' cost, at $2.52, of the entire S&P 500, $5.21. Options diluted earnings in the IT companies included in the S&P 500 by 69%, or $2.52, out of a -$3.66 loss. IT companies abuse the use of stock options <u>far</u> more than any other industry sector. It's no coincidence that earnings and share prices of IT companies have plummeted more than other sectors in the post-bubble swoon.

A Look at the Bellwethers Cisco Systems, Inc. and Intel Corp.
From each stock's high during the 2000 market bubble to its post-bubble lows: Cisco lost shareholders $502 billion (B) declining ~86% and Intel lost shareholders $401B declining 78%. CEO John Chambers was rewarded for running his company into the ground by cashing in on $851 million (MM) in stock options from January 1999 to May 2002. Cisco's management and directors had conflicting interests with shareholders. By participating in 72 acquisitions, members of Cisco's management team had opportunities to cash-in on investments they made in venture capital funds. Management consistently pushed the limits of accounting standards. Over the past four years, from 1999 through 2002, Cisco's use of options cost shareholders (26.5%), (41.9%), (166.8%), and (80.3%) of earnings. Stock options would have reduced Intel's earnings over the same period by (5.2%), (6.2%), (7.9%), and (80.3%). Andrew Grove, Intel's chairman, has long been against improving corporate governance and accounting transparency. On September 17, 2002 the Conference Board's 12-person Commission on Public Trust and Private Enterprise voted 10-2 to urge the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) to "move expeditiously to determine appropriate

accounting treatment for equity-based compensation, including uniform and broadly accepted method of valuing options," but Mr. Grove dissented.

A Look at Some Lesser Known Technology Entities

The three technology companies analyzed for stock option impact were Mercury Interactive Corporation, Rational Software Corporation, and Sanmina-SCI Corporation. Over the last trailing twelve months from September 2002, S&P reports Mercury lost 401% of its EPS value, when considering the impact of stock option expensing. Expensing of stock options in fiscal year (FY) 2002 cost Rational a 404% greater loss. By expensing stock options Sanmina-SCI's FY 2001 earnings would drop by 146%. All of these companies plummeted over 90%, from their 2000 stock price market bubble highs to their post-bubble lows. Dilution of the share count affected Ciena Corporation by over 6.4%, Siebel Systems Corporation by over 13.2%, and RF Micro Devices by over 7.1% annually. Diluting the outstanding share count by over 3% a year is considered problematic.[17] All of these companies decined over 94% from their stock price highs to their post-bubble lows. In FY 2000 Manugistic's CEO Greg Owens received 50.1% of all options granted. Arris Group, Inc.'s CEO Bob Stanzione received 54% of all stock options in 1999 and 65% of all options granted in 2001. Manugistic's and Arris' stock both declined 97% from their 2000 market bubble highs to post-bubble lows.

Some Kind Words from Mr. Rodgers' Silicon Valley Neighborhood

Cypress Semiconductor Corporation's CEO T.J. Rodgers is concerned that stock options would take away his entire firm's profits, even if the firm were extremely successful. Well, then maybe his firm really wasn't successful, because he just diluted shareholder value with the options. This is exactly the signal expensing of stock options should provide investors, so we know not to buy. Mr. Rodgers has no respect for the Financial Accounting Standards Board (FASB) or Securities and Exchange Commission (SEC); he laments, "FASB and SEC share a common governmental accounting malady. … recto-cranial insertion."[26] The FASB and SEC are revered institutions, established to protect investors from abuse and promote our capitalist system. You would think a successful entrepreneur and accomplished leader, as is Mr. Rodgers, would want to promote a fair and equitable capitalist system.

There's something for Directors, Insiders, and Venture Captialists (VCs) Too!

CEOs are not the only beneficiaries of employee stock options. Insiders, Directors, and VCs can get in on the action too, but at the expense of shareholders. Cisco suffers from conflicts-of-interest and self-dealing beyond compare. All told, thirteen Cisco executives benefited from venture fund partnerships: seven senior executives, four board members, and two aides to John Chambers. The board's purpose is to represent shareholders, not themselves, and not the management.[20] Clearly, this has been lost on Cisco's management, among others. Another company, whose board members put themselves ahead of shareholders' interests is Qwest. Philip F. Anschutz and Craig Slater, both members of Qwest's board, thought it was legitimate to do a partnership with a venture they owned through Anschutz Investment Company, called Anschutz Digital Media. When business soured in their own venture they recouped their costs by selling the firm to Qwest at inflated prices. Qwest's board had no interest in representing shareholders, the board's members represented their own self-interests – called self-dealing. Another interesting conflict-of-interest can be found on Siebel Systems, Inc.'s board. It was recently announced that The Teachers' Retirement System of Lousiana has sued Siebel over the unauthorized awarding of stock options to CEO Thomas M. Siebel and non-disclosure of option grants to board members. One director, Charles R. Schwab, was asked to return some of the "tainted shares."[25] Mr. Schwab is chairman and co-CEO of his own firm – The Charles Schwab Corporation. In 2002 Mr. Schwab netted $11.9MM in Siebel stock sales proceeds. He owns 3.4MM of Siebel shares. By Mr. Schwab accepting options from Siebel you have to question his loyalty and duty to his own firm to remain unbiased in choosing the most appropriate customer relationship management (CRM) software or to have purchased any CRM product, at all, for that matter.

I'm Glad Senator Lieberman, Representative Oxley, and Mr. Doer "Look Out for the Little Guy"
Opponents of expensing stock options contend that the rank-and-file will be harmed if we curtail stock options. Yet, most rank-and-file (those making under $75,000 annually) have minimum participation in stock option programs, so the average people getting hurt are the 94MM investors. After the top-5 executives take their 30% of options granted, the remaining 70% goes to managers and executives that make up less than 5% of employees at traditional companies. Why are we sacrificing fair, accurate, and transparent accounting for the sake of a privileged few? Executive pay compared to the average worker's pay has risen dramatically, from 25 to 40 to 1 in the '60's and '70's to 1000 to 1 today. A major reason for the income disparity is the use of stock options; 80% of CEO pay comes from stock options. Blasi and Kruse, researchers at Rutgers University, estimate that only 2% of the U.S. work force gets options every year. Corporate America grants less than 1% of its shares to regular workers.[5] In Silicon Valley some start-ups are getting laid-off workers to work for equity, without cash remuneration, a nice benefit for venture capitalists. We must cease the massive wealth transfer from investors to senior executives.

Cometh the Tax Man or, When It Comes to Stock Options, Santa Claus
Another interesting benefit afforded corporations from stock options is the ability to improve "cash flow from operations (CFO)" with the tax benefits from stock options. Note employees pay taxes on stock options when they exercise them, while companies don't; this provides a tax credit. In 2000, the S&P 500 reported an estimated total tax benefit from stock option exercise of $34.7B. The IT sector accounted for $19.4B of that figure or, 56% of all stock option tax benefits.[4] In Cisco's Q101, the tax credit for stock options accounted for 72% of the quarter's CFO. It makes no sense for a company to be receiving a tax credit, when the company isn't realizing a concomitant compensation expense.

Stock Options are the Catalyst for the Recent Corporate Scandals
Another problem with stock options is that executives may benefit personally by higher revenue or earnings per share (EPS) numbers. Since some stock options are tied to performance, enhancing performance can be a powerful incentive to misrepresent a company's results. Enron management decided to transact the Nigerian barge deal and a series of complex gas and power trades with Merrill Lynch at the end of 1999, so Enron could make its Q499 EPS target. Both deals combined permitted Enron to book $60MM in profits. On January 18, 2000, Enron announced $259MM in Q499 profits or $0.31, matching analysts' consensus expectations. Without the $60MM boost to profits, EPS would have fallen short, at $0.24. Two weeks after the earnings announcements 20 Enron executives and directors sold $82.6MM in stock.[44] Don't tell me that the excessive use of stock options wasn't the impetus for Enron's corrupt, shameful corporate behavior. The mastermind behind this deal agreed, Chairman and Chief Executive of Enron North America. He may have felt so ashamed that it led to his demise earlier this year -- his name -- J. Clifford Baxter. Enron CEO Jeff Skilling acknowledged that Senator Barbara Boxer helped to maintain the stock option exemption for the benefit of Enron's executives. Mr. Skilling made $89MM on stock options, only to be outdone by Chairman Kenneth Lay, cashing in on $247MM. Stock options provide a powerful incentive to cheat and there can be no real reform without the expensing of stock options.

The Elegance of the Black-Scholes Options Pricing Model

Black-Scholes takes into account the stock's price when the option is granted, time remaining before an option expires, interest rate, and stock's record of volatility. A drawback expressed by detractors of expensing stock options is the difficulty in forecasting the volatility, thus the future option value. Even though there may be drawbacks to Black-Scholes, volatility is not one of them. The Black-Scholes is a time tested elegant model; if a company wants the Black-Scholes to be less volatile, it must work to keep its stock price less volatile. Intuitively, if you trade options you know that the market makers always negotiate the highest "ask" price possible, so its not surprising that the Black-Scholes under-states the market price. In my own test of five technology companies, four out of the five Black-Schole's option prices, came in below the market price.

The Fallacies: Dilution Provides Enough Data, the Treasury Stock Method Results in a Wash, and Stock Options Are Necessary for a Competitive Economy

The option expense tells me how much management really costs, by only providing the diluted share count the firm grossly overstates earnings. There is no virtue in just diluting the share count, no accuracy; it's a gross exaggeration. Without expensing options, earnings don't show the purchase cost of exercised stock option shares. If for some reason the firm has non-distributed shares, never before in the hands of shareholders. Then the firm has an opportunity cost. Instead of distributing the shares to management upon option exercise, the shares could be sold and the capital used to increase working capital or capital expenditures, in addition to purchasing an entity, providing a dividend, or buying back debt. Stock options are a valuable limited resource, to be issued only after exercising extreme discretion. Some proponents of exempting the expensing of stock options contend that the stock options program creates a consistent source of cash flow; cash goes out to purchase more shares for the program, but comes back in when the options are exercised. Unfortunately, the amount going out and coming back in aren't the same, that's why some companies try to hedge the purchase price by selling put options. Put option hedging strategies have cost EDS Corporation and Dell Computer dearly, during the current stock market downturn. In 2000 Jack Ciesielski notes that S&P 500 firms took in $45.2B in options exercised, but gave away $284B worth of options granted.[4] Over the past five years Moody's shows that it costs companies roughly five times the value of the amount exercised to deliver the option shares purchased. The accounting rules are very lax when companies buy and sell options on their own stock. When companies deal with their own stock, they don't have to disclose the transaction, a driving force for conducting these risky transactions. Many proponents of exempting the expensing of stock options exclaim, we need the incentive accompanying stock options to remain competitive in a global economy and retain our employees. However, individuals working for start-ups, point out, their firms focus too much on making sales and bringing in deals, rather than building the company's inftrastructure to flourish for the long-term. Top employees are enticed to job-hop by stock-options. By expensing stock options we can make the ante that much more costly, possibly reducing job-hopping.

Other Reasons Why the Expensing of Stock Options Is Coming

Most corporations realize the expensing of stock options is coming. Roughly, 150 companies have announced they will support the expensing of stock options; 21 of those firms are members of the Financial Services Forum. A survey conducted by CalPERS found that 80% of respondents favor the expensing of stock options. The expensing of stock options will come either through the adoption of International Accounting Standards Board (IASB) or de facto. Unfortunately, options are not completely aligned with the interests of shareholders. When the stock price drops, investors take it directly in the pocket, while option holders can always reprice or issue new options. With an option, the potential for loss is small; at worst the option becomes worthless, but the gain may be tremendous. Management may even see it as advantageous to keep the stock price low until new options are priced. The Blasi and Kruse study demonstrated that companies dispensing significantly larger-than-average option grants to their top-5 executives produced decidedly lower total returns to shareholders than those dispensing far fewer options. Other studies have also concluded that increasing equity ownership to middle-level managers has a greater impact on corporate performance than to top-tier executives. Dean R. Dalton, the dean of Indiana University's Kelley School of Business, says the amount of equity executives' own does not affect their company's performance. Jack Ciesielski analysis of option heavy and light firms offered no evidence that heavy option usage itself was a determining factor in strong long-term performance.[4]

Restricting the Selling of Stock Options to Avoid Inequities – Waiting Period
Directors and executive officers should be restricted from selling their equity holdings except to cover income taxes in company stock while serving in that company.[63] Insiders have an unfair advantage under the current unrestricted selling environment. Oracle's CEO, Lawrence J. Ellison, sold over 51MM shares in January of 2001 (note, I've seen higher numbers when including the period prior to January), before warning investors that Oracle Corporation would not make Q301 guidance, ending February 2001. At the time, the stock was trading above $30.00; it never recovered and slid to under $10.00 in May 2002, roughly a 70% decline. The Securities and Exchange Commission (SEC) should repeal the 1991 rule that allows executives to cash-in stock options immediately, without a waiting period, i.e., automatic selling. Manugistics Group Inc. and Applied Micro Circuits Corporation (AMCC) have taken advantage of early stock option exercise. AMCC's CEO, David Rickey, sold 99% of his shares, making $170MM, with eight to nine years, yet to exercise options, so much for aligning with shareholders.

Conclusion
Stock options are compensation, they're salary, and they're a credit on taxes, so they should be expensed. Not expensing stock options creates erroneous earnings by leaving out a true expense. Exempting the expensing of stock options distorts the market's perception of an option heavy entity, causing a mis-allocation of capital flow and eventually causing an industry glut. Could it be that the option heavy sectors, Information Technology and Telecommunications, weren't evaluated properly; that too much capital chased these sectors, and the over-building squeezed out future profits for everyone? Companies should have incentives to give restricted stock, instead of relying on stock options. When firms award stock options the exercise price should be indexed, so if the index moves, so does the exercise price. In the current environment, standard stock options give windfalls to executives in a bull market and penalize them in a bear market. From 1997 to 2001, the top-5 executives at the average American company shared $31.6MM in profits from exercising stock options. If the biggest factor affecting a firm's performance is the economy, then all employees should participate, not just the top-5. Companies should be required to use incentive based options, which must be expensed under current accounting rules.[68] Only 16% of the largest U.S. companies have granted performance based options. The bottom line: waiting for the footnotes in the 10K is too late to find the extreme EPS damage done by stock options. As an analyst, I need up-to-date data every quarter; I can't wait until the end of the year to discern the EPS damage. By expensing stock options we place discipline on management, which should rein in the excessive use of options. Stock options provide a powerful incentive to cheat and there can be no real reform without the expensing of stock options.[49] The damage to earnings is real; this does not come for free, and not expensing options is a gross exaggeration of earnings. An option is NOT FREE.

Introduction

I was aghast to learn that California Public Employees' Retirement System's (CalPERS') board decided not to endorse the expensing of employee stock options at the April 15, 2002 Investment Committee

Meeting. It remains unanimously neutral on the issue. CalPERS' board should conduct itself as a fiduciary for plan participants and beneficiaries. A fiduciary is someone who acts for the benefit of someone else. Fiduciaries owe undivided loyalty to their clients and must place client's interests before their own. Extra care must be taken if the fiduciary has direct control. By not embracing the expensing of stock options they tell me CalPERS' board did not breach its fiduciary duty to plan participants and their benificiaries. Since it's a state pension fund, CalPERS doesn't have to adhere to the Employee Retirement Income Security Act (ERISA) principles designated for corporate pension plans. Rightfully so, the board conducted its due diligence. But I contend, if they didn't breach their fiduciary duty then what do they have to do to compromise our faith in their loyalty to plan participants and beneficiaries? If this wasn't a breach of fiduciary duty to exercise care and loyalty then what is? At best, the board conveniently skirted the issue, so as not to antagonize key consitituents; at worst, it neglected its duty and compromised itself to the special interests of TechNet, i.e., high tek chief executive officers (CEOs), venture capitalists (VCs), and other stakeholder friends whose interests deviate from investors.

TechNet is a national network of 300 senior executives of the nation's leading technology companies (find more details about the group at www.technet.org). TechNet's mission is to build bipartisan support for policies that strengthen America's leadership of the New Economy by persuading politicians through strong-arm tactics. Through TechNet's vigilance individual investors don't stand a chance of getting shareholder friendly legislation. TechNet has organized an exemplary campaign to keep the expensing of stock options and other reforms out of legislation.

It's easy for TechNet to offer *quid pro quo* to our elected federal and state officials, Senator Barbara Boxer, Senator Joe Lieberman, Representative Michael Oxley, Senator Tom Daschle, and California Governor Gray Davis; but the board of a pension fund, TechNet has gone to dastardly lengths. The CEOs made tremendous profits before and after the boom at the expense of shareholders. Shareholders and the CalPERS pension fund sustained unprecedented losses, yet the CalPERS board sides with TechNet, not the postion of CalPERS' staff.

California's treasurer, Phil Angelides, in response to the issue of expensing stock options stated, "our underlying concern always must be and preeminently the fiduciary interests of this system. I do think it's relevant to this California system ... I don't think there's any dispute that options are hard to value. ... There is no standard methodology." In regards to his thoughts on stock market impact of options, "I was compelled by your agument that said there was none ... the market already had a level of information that allowed it to calibrate options." And how does Mr. Angelides feel about the expensing of stock options? "Really do believe in many ways this is not an expense, this is an equity transfer, ... as to whether we rally around this as a central thing that brings stability back to the markets. So I don't believe it. ... I personally don't believe expensing of options gives the answer." I agree, Mr. Angelides. We have had an "equity transfer" from 94MM investors to CEOs and venture capitalists. From there, to some politician's campaign war chest.

It's clear from Mr. Angelides' argument that he worries more about the effect of expensing stock options on California's high technology industry than on the 1.3 million CalPERS' plan participants. Plan returns are negatively impacted by the exempting of the expensing of stock options. Second, he believes TechNet's specious contention that there is no standard options valuation methodology. This is blatantly not true. We have the Black-Scholes – a proven and time tested -- methodology and it works. Third, analysts do not have the level of information to calculate the effect of stock options; it's not timely, we need option expensing information in the quarterly earnings per share in the income statment. Mr.

Angelides is correct, there is an equity transfer, from shareholders to executives. How about we shift some of that transfer back to plan participants?

Last, there is no reform without the expensing of stock options. Mr. Angelides does not represent the best interests of his pension fund constituents, he represents TechNet's interests. It's no coincidence that the ten option heavy technology companies I studied lost shareholders on average 93% of their value from their 2000 market bubble's peak. Or that the two most option heavy sectors, Information Technology (48.4%) and Telecommunications (5.0%), historically, in the S&P 500 were the only two sectors twelve months trailing from June 2002 that lost earnings. Could it be that these sectors weren't evaluated properly, that too much capital chased these sectors, and the over-building squeezed out future profits for everyone? I believe the lack of expensing for stock options had a great deal to do with the erroneous equity valuations. CalPERS' neutral position on the expensing of stock options is particularly disturbing when considering TIAA-CREF's position and the Council of Institutional Investors – a pension fund lobbying group. Not only is it disturbing, but also shocking.

TIAA-CREF came out strongly for SFAS 123, Accounting for Stock-Based Compensation, as have many other patriots like Senator John McCain, Former SEC Chairman Arthur Levitt, CEO of Berkshire Hathaway Warren Buffett, Federal Reserve Chairman Alan Greenspan, Vanguard founder John C. Bogle, and Senator Carl Levin. This group has made convincing arguments against exempting the expensing of stock options. To date, 150 enlightened companies announced vountarily expensing employee stock options. The specious argument for keeping the status quo goes against providing investors with timely transparent information; rather, it promotes egregious CEO pay packages and gluttonous compensation for venture capitalists at the expense of shareholders' wealth.

John H. Biggs, TIAA-CREF's CEO, strongly endorses the expensing of stock options. According to Mr. Biggs, "companies ensure zero 'cost' for standard options. This is, of course, a fiction ... Perhaps even more distressing it encourages excessive – in some cases profligate – use of options." TIAA-CREF is on a campaign to persuade companies to support the expensing of employee stock options.[0] You would think a pension fund, like CalPERS, that just sustained over ~20% losses in its portfolio, would want to do everything in its power to give shareholders the best ability to analyze equity value; but the CalPERS board thought otherwise. How does TIAA-CREF come to one conclusion on this issue, and CalPERS' board another? Another strange element of its decision was making it against the recommendation of CalPERS staff at the April 15, 2002 Investment Committee Meeting. See the site www.calpers.ca.gov, click on the scroll down hyper-link in "of Special Interest" labeled "Board Meeting Information" then press on the hyper-link "Board Agenda Archive." Once there you want to select "April" and then "Investments," zero in on "Action/Information 6. Public Markets" and press on the hyper-link "B. Corporate Governance & Financial Markets and Reforms" for CalPERS' management presentation to support the expensing of stock options. Staff's recommendation was trumped by TechNet or the *Greedy Bunch*.

I believe that equity ownership by employees is good for shareholders and we shouldn't do away with stock options. If a company grants stock options shareholders should be aware of that cost immediately. Yes, it's important to support technology companies and California's economy, but not at the expense of our nation's capital markets. As Teddy Roosevelt said almost a century ago, "We draw the line against misconduct, not against wealth. The capitalist who, alone or in conjunction with his fellows, performs some great industrial feat by which he wins money is a well-doer, not a wrong doer, provided he works in the proper and legitimate lines." Exempting the expensing of stock options is illegitimate.

The Effects of Stock Options on Earnings Per Share (EPS)

My job is to analyze technology companies. I've been astounded by the affect of stock options on EPS (E/S: earnings/shares), in both the E-earnings numerator and S-shares denominator. From my experience, the use of employee stock options by technology companies is out of control by both the wanton distortion in earnings and dilution of shareholder value. Standard & Poor's EXECUCOMP put stock options at 30% of all CEO compensation in 1993 to 68.8% of all compensation in 2000.[1] *Business Week* cites options as currently accounting for 80% of executive compensation. The typical large company CEO salary is now $11million (MM).[2] *USA Today* asserts that in 2001 CEOs gained on average $11.4MM in stock options. In the United Kingdom more than half the value of total CEO pay at the country's 100 largest companies consists of stock options and free shares tied to performance.[3]

The use of stock options grows more prevalent every year, and with it, more distortions. A William M. Mercer 1999 *USA Today* study shows options going to at least half of employees rose from 17% in 1993 to 39% in 1999. A Paul Meyer survey of the top 200 US companies shows annual grants as a percent of shares outstanding nearly doubling from 1.15% in 1990 to 1.64% in 1995 to 2.2% in 2000. Jack Ciesielski says options compensation is growing faster than earnings, 56% compound annual growth rate (CAGR) from 1998 through 2001.[4] Blasi and Kruse, researchers at Rutgers University, calculate that in 1992 the top-5 executives at the largest 1,700 U.S. companies collected $2.4B in stock option capital gains. In 2000 that increased to $18B, a 750% gain. Over this same period remaining option paper profits jumped from $7B to $80B.[5] In the last ten years options have risen from 5% of shares outstanding at major companies to 15%.[6] Sanford Bernstein & Company claims the value of options granted increased from $50B in 1997 to $162B in 2000. In 2000 the average chief executive was awarded 715,000 options, a 50% increase over 476,000 options in 1999.[7] The missing cost of options gets greater and greater every year, and more perverse.

Option expensing would have shaved 3% off of earnings growth for the 500 largest companies from 1995 to 2000 or a reduction from 9% to 6% growth.

According to Jack Ciesielski, in 2000, 77 information technology and 13 telecommunication services companies overstated earnings by 33% and 12%, respectively, while the rest of the S&P 500 overstated earnings by 9%. Exempting the expensing options inflated S&P 500 earnings by 31% in 2001, over a three fold change over 2000's 9%.[8] Every year from 1995 through 2001 this over-statement has increased. The Information Technology (IT) sector accounts for 15% of the EPS and 44% of the stock compensation of the S&P 500.[4]

Moody's took a different cut at the data, according to annual reports, expensing of stock options would have reduced the aggregate net income of the S&P 100 by 5%, 7%, and 16% from 1999 through 2001.[9]

S&P 100 Earnings Effects

$ Billions	**1999**	**2000**	**2001**
Reported earnings	242.4	260.3	171.3
Unrecorded compensation*	12.1	18.0	23.8
Net earnings	230.3	242.3	147.5
Overstatement of net earnings	5%	7%	16%

*reflects vested amount
Source: R.G. Associates, Moody's

The following chart takes a more recent cut at employee stock option data.

12 Months June 2002 EPS
S&P 500 Impact Data

S&P 500 Sectors	As Reported Net Income	Option Grant Expense	Percent % of Net Income	Percent % Total Option Expense
Consumer discr.	$3.07	-$0.54	17.6%	10.4%
Consumer staples	4.44	-0.23	5.2	4.4
Energy	2.26	-0.09	4.0	1.7
Financials	10.53	-0.68	6.5	13.1
Health Care	5.25	-0.45	8.6	8.6
Industrials	3.66	-0.29	8.0	5.6
Information tech	**-3.66**	**-2.52**	**68.9**	**48.4**
Materials	0.63	-0.08	12.7	1.5
Telecom svcs.	**-1.93**	**-0.26**	**13.5**	**5.0**
Utilities	2.49	-0.07	2.8	1.3
Total	$26.74	-$5.21		100.0%

Unfortunately, even during the down-turn experienced in the twelve months prior to June 30, 2002 the dilutive effects of options has expanded. During this latest period, reported by S&P, stock options overstated earnings of the S&P 500 by 19.5% or $5.21, out of $26.74 earned. IT companies were responsible for 48.4% of the options' cost, at -$2.52, of the entire S&P 500, $5.21. Options diluted earnings in the IT companies included in the S&P 500 by 69% or -$2.52 out of a -$3.66 loss. IT and telecommunications were both drags on S&P 500 earnings, at negative -$3.66 and -$1.93, respectively, out of $26.74 in net income.[10] IT companies abuse the use of stock options far more than any other industry sector.

A Look at the Bellwethers Cisco Systems, Inc. and Intel Corp.

Let's take two high technology bellwether entities: Cisco Systems, Inc. and Intel Corp. Both companies are TechNet members. With all the scrutiny these two are under, you would think that these two high technology bellwethers would do their utmost to maintain shareholder value, in both the earnings and share count component.

Cisco Systems, Inc.

From March 24, 2000 until September, 27, 2001 Cisco lost shareholders $502B, the stock declined ~86%. For a superb job of over producing, paying billions in shares of stock for worthless acquisitions, writing off $4B in impaired investments, and writing off $2.5B in worthless inventory, John Chambers was rewarded by making $226.7MM in FY01 compensation.[11] Over the years Cisco was a systemic abuser of restructuring charges. When things got bad in early 2001 it wreaked havoc down the supply chain, and in April 2001 layed-off 8,500 of employees. From January 1999 until May 2002 CEO John Chambers cashed in on $851MM in stock options.[12]

After Cisco management grossly overestimated the order backlog and continued expanding operations, during Q301, ending April 2001, investors began to question Cisco's veracity. One analyst, Ariane Mahler, of Dresdner Kleinwort Wasserstein, exclaimed Cisco used "aggressive accounting," had "artificially inflated" its gross margins by taking write-downs, $2.5B, on the value of its inventory that could help the company “pad“ future results. The company aggressively applies accounting standards that make results look better than they are.[13] In Q102 Cisco disclosed earning $290MM on selling excess inventory, written off as worthless seven months before.[14] Analysts and investors alike were confused by Cisco’s accounting. In August 2001 Ms. Mahler gave Cisco a “reduce“ or “sell“ recommendation.

Investors should beware that Cisco has paid its accountant, PricewaterhousCoopers, on average 87% of its $17MM in annual fees for non-auditing work over the last two years, fiscal years 2002 and 2001. A heavy commitment to non-auditing fees may entice an accountant to look the other way when encountering accounting grey areas. To Cisco’s credit, from now on, the board will limit non-auditing fees with any one accounting firm to 25% of all fees.

Management’s gaffe would cost 8,500 workers their jobs. Most of those workers, 5000, were hired between November 2000 and March 2001. Many admit that Cisco’s management should have seen the slow-down coming, yet, Mr. Chambers kept clinging to his 60% revenue growth forecast. Cisco‘s contract manufacturer, Solectron, warned them during the summer that they were ordering more parts than needed. For the first time in six years, Cisco would not meet its quarterly EPS projections. Not meeting analysts‘ $0.19 earnings projection meant a melt-down in stock value, underwater stock options, and an end to stock based acquisitions.[15]

On April 1, 2001 Mr. Chambers generously lowered his base salary to $1.00. We can only surmise, he felt bad laying-off newly hired employees, yet in the July 28, 2001 Proxy Mr. Chambers was awarded 6MM stock options or 2.0% of all options granted. Especially magnanimous, the board decided that 2MM of those options should be granted at roughly ¼ the ~$79.00 equities‘ March 24, 2000 high or at $18.57. The Proxy also indicated that Mr. Chambers owned 21.4MM shares or $406MM worth of Cisco’s shares. I don’t think it’s an overstatement to call Mr. Chamber’s compensation package obscene and a direct attack on shareholders‘ value. Are more options really an incentive? His only incentive is to diversify when the stock price comes back. More importantly, Mr. Chambers can run the company into the ground, yet still come up a winner.

In May 2001 *Bloomberg* indicates that new options were issued to employees at an exercise price of as much as 79% lower than the past highest grant. Needless to say, Cisco’s insiders did not share the pain with investors nor did the venture capitalists, who garnered great profits in Cisco’s failed acquisitions.

Cisco Squandered Shareholders‘ Value Through Acquisistions

In a clear conflict-of-interest CEO John Chambers invested $50,000 in a venture capital partnership called Sequoia Technology Partners, which subsequently invested in Monterey Networks, StratumOne Communications, Ardent Communications, and Pipelinks.[16] Later, Cisco acquired these companies and John Chambers voted on all the deals. SEC filings indicate that twelve of Cisco’s mergers were funded through Sequoia Capital partnerships. Ultimately, Cisco participated in 72 acquisitions since 1993, when the stock was peaking Cisco was paying $24MM per acquired employee – Cerent 285 employess at $6.9B. The irony of paying this much per employee is that many of these employees left, siphoning off shareholders‘ wealth.

Mr. Chambers has exhibited a consistent pattern of abusing accounting practices to mask poor management decisions, especially when it comes to acquisitions. Not surprising, former Securities and Exchange Commission (SEC) Chairman Arthur Levitt in his book, *Take on the Street: What Wall Street and Corporate America Don’t Want You to Know*, reflects on a meeting with Mr. Chambers and Kleiner Perkins Caulfield & Byers‘ VC Mr. John Doer over reining in the merger accounting standardsetters. Mr. Chambers liked the current system of "pooling accounting," because it hid the costs of over-paying for assets. Needless to say, Mr. Chambers has made a career out of over-paying for acquisitions, i.e., with shareholders' equity. When Mr. Chambers and Mr. Doer didn't like Mr. Levitt's response to their request, "they threatened to get 'friends' in the White House and on Capitol Hill to make me bend." When you have Mr. Chamber's money, you attract many political "friends."

The accounting at Cisco is suspect. Only the naive faithful could believe that Cisco's EPS truly represents real earnings. Cisco regularly billed small restructuring charges – hoping that analysts and investors would disregard the charges, making the EPS look better. *Forbes* magazine lists Cisco as one of the "serial chargers," consistently abusing the ability to take non-recurring restructuring charges every quarter. Cisco was never as profitable as management would like us to believe.

The Impact of Options on Earnings is Extraordinary

If options were expensed, Cisco's fiscal year (FY) 2001 loss would have been 167% worse, instead of a ($1,014MM) loss, it would have been a ($2,705MM) loss. In fiscal years 1999, 2000, and 2002 expensing of stock options' impact on profits would have reduced net income by 27%, 42%, and 80%, respectively. Cisco's stock options are a tremendous drag on earnings and not to be ignored.

Shares outstanding at Cisco have grown at a whopping 57.4% compound annual growth rate (CAGR) from 1996's 3.6B to 2001's 35.2B. From 1999, 2000, 2001, and 2002 Cisco management diluted their shares by 6.3%, 7.5%, 5.95, and 9.8%, respectively by the effect of employee stock options found in Note 14 and Note 13 of Cisco's 2001 and 2002 10Ks, respectively. Corporate governance pundits indicate exceeding 3% options dilution annually reaches the egregious zone.[17] Over the last trailing twelve months from July 2002 S&P has Cisco losing 48% of its EPS value, from $0.25 reported to $0.13 core earnings, due to stock options. Cisco's dilution is too high. Mandatory expensing of options could cut annual earnings by ~50% in the future, maybe more.

Cisco Systems, Inc. Effects of Stock Options

Cisco Systems, Inc.	1999	2000	2001	2002
Net income – as reported	$2,023MM	$2,668MM	($1,014MM)	$1,893MM
Net income after expensing options	1,487MM	1,549MM	(2,705MM)	373MM
Diluted earnings per share (EPS)	0.29	0.36	(0.14)	0.25
Diluted EPS after expensing options	0.21	0.21	(0.38)	0.05
Effect of stock options	(26.5%)	(41.9%)	(166.8%)	(80.3%)
Shares outstanding	6,646MM	6,917MM	7,196MM	7,301MM
Effect of options distribution	416MM	521MM	426MM*	858MM*
Effect of dilution	6.3%	7.5%	5.9%	11.8%

*for 2001 and 2002, 426MM and 712MM shares, respectively, were not included in diluted shares, because the exercise price of the stock options was greater than the average share price of the common shares.

To further show Cisco's lack of concern for shareholder value, after laying off 6,000 workers, management decided to extend the layed-off employees' stock option exercise period to one year, instead of the normal 90 days. It stretched the period, because it was unlikely that employees would be able to take advantage of the grant in the next 90 days. Benefits experts cited Cisco's move as a rare one.[18]

Cisco's recent solution to a low stock price: buy back $8B worth of stock with cash that never affects the EPS. It's a vicious cycle, with management using cash originally contributed by shareholders.

Intel Corp.
Intel, another bellwether, from September 1, 2000 until September, 3, 2002, lost shareholders $401B, the stock declined 78%. Instead of making $1.29B in 2001 net income, Intel would have made 80% less by expensing options or $254MM. Net income would have been reduced by 5% through 8% from fiscal years 1998 through 2000, respectively. From 1998 until 2001 Intel diluted their shares from 2.4% through 4.8%, corporate governance pundits recommend not exceeding 1% annual options dilution.[17]

Intel Corporation Effects of Stock Options

Intel Corp.	1998	1999	2000	2001
Net income – as reported	$6,068MM	$7,314MM	$10,535MM	$1,291MM
Net income after expensing options	5,755MM	6,860MM	9,699MM	254MM
Diluted earnings per share (EPS)	0.86	1.05	1.51	0.19
Diluted EPS after expensing options	0.83	0.99	1.40	0.04
Effect of stock options	(5.2%)	(6.2%)	(7.9%)	(80.3%)
Shares outstanding	6,672MM	6,648MM	6,709MM	6,716MM
Effect of options distribution	318MM	289MM	272MM	163MM
Effect of dilution	4.8%	4.4%	4.0%	2.4%

Over the last trailing twelve months (TTM) from June 2002 S&P has Intel losing 21% of its EPS value, from $0.29 reported to $0.23 core earnings, due to stock options.

Andrew Grove: Modern Day Silicon Valley Robber Baron
Andrew Grove, Intel's chairman, has long been against improving corporate governance and accounting transparency. He managed to scale back a provision in the Sarbanes-Oxley Act imposing prison terms of up to 20 years for senior corporate executives who knowingly publish misleading financial statements. The provision exempts non-executive board chairmen, like Mr. Grove, from prosecution.[19] Mr. Grove's stong stance, since 1994, against the expensing of stock options and exemption for directors continues to send the wrong message. If Mr. Grove doesn't want to be responsible for maintaining the integrity of a corporation then he shouldn't be on the board. The board has to be accountable. The board's purpose is to represent the shareholders, not themselves, and not the management.[20] This definition of purpose is completely lost on Mr. Grove.

Since 1990 Mr. Grove has raised more than $160MM by selling shares, many acquired by exercising stock options.[21] Even with the depressed equity price in 2002, Intel insiders sold roughly $40MM in stock, while Mr. Grove's net proceeds came to $9.6MM.[22] Intel's 2002 stock performance was in the bottom 20% of the S&P 500, yet insiders still found it an opportune time to sell at depressed prices. What do they know that we don't? Mr. Grove was CEO from 1987 to May 1998 and President of Intel from 1979 to 1997. Good corporate governance procedures stress board independence, Mr. Grove's long tenure at Intel makes him an insider, a poor candidate for an objective chairman of the board.

On September 17, 2002 the Conference Board's 12-person Commission on Public Trust and Private Enterprise voted 10-2 to urge the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) to "move expeditiously to determine appropriate accounting treatment for equity-based compensation, including uniform and broadly accepted method of valuing options," but Mr. Grove dissented.[23]

In a recent question and answer session, Mr. Grove indicated that the expensing of stock options should be settled by non-political means, but by the FASB going away on a deserted island and thinking about it.[24]

What a disengenuous statement, Intel participates in TechNet and has been a major protagonist in making sure the expensing of options never comes about. Oh, how much better-off shareholders would be now if Mr. Grove took his own advice.

In 1994, members of the FASB were threatened by congress, led by Senator Joseph Lieberman, with the loss of their accounting rule making ability, if they followed through with rules for the expensing of stock options. Again, in 1997, congress was urged by the special interests not to pass S. 1940, "Ending the Double Standard for Stock Options Act." Congress, tainted by special interests, also threatened Arthur Levitt's SEC budget. Corporate lobbying and quid pro quo arrangements aimed at persuading politicians to crush employee stock option expensing has been intense. This accounting charade has been going on for eight years; please, show some integrity and ethical behavior.

Not only did Senator Lieberman mobilize congress to block legislation to thwart the expensing of stock options, but also he's supported restrictions on shareholder friendly lawsuits against companies and their accountants. Mr. Lieberman is no friend to 94MM investors.

A Look at Some Lesser Known Technology Entities

In fiscal year (FY) 2001 Mercury Interactive Corporation earned $34.1MM. If you include expensing options Mercury lost ($89.9MM), or a 263% drop in earnings. The prior year, instead of Mercury gaining $64.7MM, it made only $1.1MM when including option expenses, a 98% decline in earnings. Over the last trailing twelve months from September 2002 S&P reports Mercury lost 401% of its EPS value, from $0.27 reported to ($1.12) core earnings, due to stock options.

Rational Software Corporation lost ($75.9MM) in fiscal year 2002. By expensing stock options the loss would have been ($382.5MM) or a 404% greater loss. During 2001 Rational reported a $72.1MM earnings gain, but by expensing options the loss would have resulted in a 204% drop to a ($146.5MM) loss. Over the last trailing twelve months from September 2002 S&P has Rational losing 651.7% of its EPS value, from ($0.29) reported to ($1.89) core earnings, due to stock options.

Sanmina-SCI Corporation reported 2001 earnings of $40.5MM. By expensing stock options the firm would have lost ($18.8MM), a 146% decline in earnings. Expensing stock options slices 78% off of 1998's Sanmina-SCI earnings. Over the last trailing twelve months from September 2002 S&P has Sanmina-SCI losing 9.9% of its EPS value, from ($0.71) reported to ($0.78) core earnings, due to stock options.

Expensing stock options had a <u>tremendous</u> <u>impact</u> on the earnings of some companies CalPERS invested in, would you believe the afore mentioned Mercury, Rational, and Sanmina-SCI. When adjusted for options too many technology firms go from profit to loss. Eventually, the equity price succumbs to the heavy burden of stock options and all these firms have exhibited staggering stock price declines. From its high of $156.75 on September 29, 2000 Mercury stock dropped to $15.74 on October 7, 2002, a 90.0% decline. Rational declined from $69.38 on September 29, 2000 to $4.30 on October 4, 2002, a 93.8% drop. On September 1, 2000 Sanmina-SCI traded at $57.84, at its low on October 18, 2002 it traded at $1.81, a 96.9% swoon. All of these companies plummeted over 90%, from their highs during the 2000 market bubble to their post-bubble lows.

IBM recently (December 2002) announced purchasing Rational for $10.50 a share, or $2.1B. The price tag comes in far below its ~$70.00 per share market bubble highs. Rational abused the use of stock options, making analysis impossible. IBM determined a valid price, only after thorough due diligence, something investors couldn't do.

Mercury Interacitve Corporation Effects of Stock Options

Mercury Interactive Corporation	1998	1999	2000	2001
Net income – as reported	$19,525M	$33,144M	$64,700M	$34,154M
Net income after expensing options	7,882	13,895	1,097	(89,914)
Diluted earnings per share (EPS)	0.25	0.39	0.70	0.20
Diluted EPS after expensing options	0.10	0.16	0.01	(1.00)
Effect of stock options	(59.6%)	(58.1%)	(98.3%)	(263.3%)

Rational Software Corporation Effects of Stock Options

Rational Software Corporation	1999	2000	2001	2002
Net income – as reported	$59,249M	$85,314M	$72,144M	($75,948M)
Net income after expensing options	13,635M	20,089M	(147,460M)	(382,524M)
Diluted earnings per share (EPS)	0.32	0.45	0.35	(0.39)
Diluted EPS after expensing options	0.07	0.11	(0.78)	(1.98)
Effect of stock options	(77.0%)	(76.5%)	(204.4%)	(403.7%)

Sanmina-SCI Corporation Effects of Stock Options

Sanmina-SCI Corporation	1998*	1999	2000	2001
Net income – as reported	$33,198M	$104,716M	$210,094M	$40,446M
Net income after expensing options	7,452M	87,265M	162,794M	(18,778M)
Diluted earnings per share (EPS)	0.26	0.35	0.65	0.12
Diluted EPS after expensing options	0.06	0.29	0.48	(0.06)
Effect of stock options	(77.6%)	(16.7%)	(22.5%)	(146.4%)

*From the 9/30/2000 10K, does not include SCI merger.

In regards to dilution, in 1997, 1998, and 2000 stock options diluted Ciena Corporation sharholders by 7.6%, 8.4%, and 6.4%. The interesting aspect about Ciena is that the shares outstanding have increased 170% over four years. In 1998, 1999, 2000, and 2001 stock options diluted Siebel Systems Corporation shareholders by 13.2%, 19.6%, 22.7%, and 14.4%, respectively. It would be an understatement to say that Siebel's option grants are out of control. In 1999, 2000, and 2001 stock options diluted RF Micro Devices, Inc. by 7.7%, 8.2%, and 7.1%. Dilution above 3% is viewed as being in the egregious zone.[17] Siebel is in a class by itself when it comes to diluting shareholder value. According to Gretchen Morgenson, CEO Tom Siebel exercised almost six million options and realized $321MM related to them from 1998 to 2001. In 2000 and 2001 Mr. Siebel received 8MM options annually. The Teachers' Retirement System of Louisiana has sued Siebel over the undisclosed distribution of options to Mr. Siebel and the board.[25]

Again, shareholder value took a tremendous hit. Ciena, Siebel, and RF Micro Devices stock value declined 98.4%, 95.2%, and 94.1% from their highs during the 2000 market bubble to their post-bubble lows.

Ciena Corporation Effects of Stock Options Dilution

Ciena Corporation	1998	1999	2000	2001
Shares outstanding	235,980M	267,042M	281,621M	311,815M
Effect of options distribution	19,808M	--	18,041M	--
Effect of dilution	8.4%	--	6.4%	--

Siebel Systems Corporation Effects of Stock Options Dilution

Siebel Systems Corporation	1998	1999	2000	2001
Shares outstanding	364,964M	387,867M	423,067M	457,031M
Effect of options distribution	48,121M	76,190M	95,886M	65,690M
Effect of dilution	13.2%	19.6%	22.7%	14.4%

RF Micro Devices Inc. Effects of Stock Options Dilution

RF Micro Devices Inc.	1999	2000	2001	2002
Shares outstanding	136,944M	158,728M	161,820M	165,827M
Effect of options distribution	10,528M	12,940M	11,396M	--
Effect of dilution	7.7%	8.2%	7.1%	--

Manugistics Corporation and Arris Group Inc. Bastions of Egalitarianism

Manugistics' earnings were 0.6 to 3.7 times worse when considering the expensing of stock options from 2000 through 2002. In fiscal year (FY) 2000 CEO Greg Owens received 50.1% of all options granted, while the top-5 executives received 65.1% of all the options granted. In 1999, 2000, 2001, and 2002 shareholders were diluted by 4.9%, 6.9%, 12.9%, and 8.2%, respectively. Over five years shares outstanding grew at a 9.7% CAGR. Shareholders have not fared well either. On November 3, 2000 the equity peaked at $60.25, at its low on October 10, 2002 it closed at $1.67, a 97% loss for investors. Needless to say, management has faired well at the expense of shareholders over this period. The share count dilution was tremendous.

Manugistics Group, Inc. Effects of Stock Options

Manugistics Group, Inc.	1999	2000	2001	2002
Net income – as reported	($96,112M)	($8,945M)	($28,078M)	($115,158M)
Net income after expensing options	($105,188M)	(24,211M)	(75,314M)	(182,217M)
Diluted earnings per share (EPS)	(1.82)	(0.16)	(0.48)	(1.69)
Diluted EPS after expensing options	(1.99)	(0.44)	(1.28)	(2.68)
Effect of stock options	(9.4%)	(270.7%)	(168.2%)	(58%)
Shares outstanding	52,804M	54,972M	58,955M	67,986M
Effect of options distribution	2,600M	3,800M	7,600M	5,600M
Effect of dilution	4.9%	6.9%	12.9%	8.2%

The Arris Group, Inc., another bastion of egalitarianism, gave CEO Bob Stanzione 54% of all employee stock options granted in 1999 and 65% of all options granted in 2001. From 1998 through 2000 option grants diluted the shares outstanding from 4.2% to 6.2%, a substantial dilution. When the stock was trading high, 24% through 45% of earnings went to support the stock option expense. There's nothing like an incentive for the rank-and-file. Arris stock dropped from a high of $58.34 on March 3, 2000 to a low of $1.58 on October 29, 2002, a 97% decline.

Arris Group, Inc. Effects of Stock Options

Arris Group, Inc.	1998	1999	2000	2001
Net income – as reported	$5,825M	$16,710M	$20,669M	($167,731M)
Net income after expensing options	$3,204M	$12,766M	$14,454M	($176,991M)
Diluted earnings per share (EPS)	0.15	0.43	0.52	(3.13)
Diluted EPS after expensing options	0.08	0.35	0.38	(3.30)
Effect of stock options	(45.0%)	(23.6%)	(30.1%)	(5.5%)
Shares outstanding – as reported	37,195M	36,600M	37,965M	53,624M
Effect of options distribution	1,556M	2,267M	1,606M	--
Effect of dilution	4.2%	6.2%	4.2%	--

Some Kind Words from Mr. Rodgers' Silicon Valley Neighborhood

My paper wouldn't be complete without some sage comments about expensing stock options from Cypress Semiconductor Corporation's CEO T.J. Rodgers. First, Mr. Rodgers believes this change "is another phony balance sheet transaction." Of course, Mr. Rodgers, not being an accountant, wouldn't be expected to know that the major impact is to the income statement. Second, Mr. Rodgers acknowledges, "If you give stock options to your employees, you could be extraordinarily successful and never once make a profit in any quarter when reporting GAAP earnings." What an insightful observation; if this occurs, investors know your firm is not worth investing in. This is exactly the signal expensing of stock options should provide investors, so we know, not to buy.

Mr. Rodgers has no respect for the Financial Accounting Standards Board (FASB) or Securities and Exchange Commission (SEC); he laments, "FASB and SEC share a common governmental accounting malady. … recto-cranial insertion." The FASB and SEC are revered institutions, established to protect investors from abuse and promote our capitalist system. Mr. Rodgers has never been a proponent of equanimity or espoused policies for the common good; instead, Mr. Rodgers prides himself as a true

Silicon Valley student of Machiavelli. You would think a successful entrepreneur and accomplished leader, as is Mr. Rodgers, would want to promote a fair and equitable capitalist system. Instead of disparaging the institutions and systems where he thrives, he should be striving for consensus and improvement, but that is not the way of most Silicon Valley CEOs.[26]

There's something for Directors, Insiders, and Venture Captialists (VCs) Too!

Insider Conflicts at Cisco Systems, Inc.

CEOs are not the only beneficiaries of employee stock options. Insiders, Directors, and VCs can get in on the action too, but at the expense of shareholders. From Cisco's proxy, "non-employee directors were also eligible to participate in the Discretionary Option Grant Program in effect under the 1996 Stock Incentive Plan and to receive periodic option grants under the Automatic Option Grant Program in effect under the 1996 Stock Incentive Plan. Directors who are also employees of the Company are eligible to receive options under the Company's 1996 Stock Incentive Plan and to participate in the Company's 1989 Employee Stock Purchase Plan, 401(k) Plan, and Management Incentive Plan." Cisco suffers from conflicts-of-interest and self-dealing beyond compare.

Nine Cisco officers and directors invested in Sequoia funds, especially Vice Chairman Don Valentine (2.5MM shares). Mr. Valentine was not only Cisco's vice chairman, but he also invests in eleven Sequoia partnerships where he serves as general partner. At one point, six separate Sequoia partnerships held Cisco shares. All told, Mr. Valentine had to recuse himself from participating in votes on $7B worth of Cisco's merger and acquistion (M&A) outlays. You have to wonder why Mr.Valentine even serves on this board, his conflict is egregious.

CFO Larry Carter (4.1MM shares), chairman John Morgridge (83.5MM shares), outside director Carol Ann Bartz (313.9M shares), and Acquisition Manager Mike Volpi (1.6MM shares) exposed themselves to conflict-of-interests by investing in Sequoia funds.[27] All told, thirteen Cisco executives benefited from venture fund partnerships, seven senior executives, four board members, and two aides to John Chambers. There are other examples of conflict-of-interest among Cisco employees and their outside business interests. Cisco Vice President Donald Listwin received $21.5MM from startup "Software.com" and Vice President Andreas Bechtolsheim benefited from Cisco's acquisition of "Precept Software, Inc."

Monterey Networks was purchased for 7.3MM shares of Cisco stock worth $517MM in September 1999. This acquisition has come under particular criticism, because after paying such an exorbitant price Cisco shut down the operation, writing off $108MM, without ever bringing a product to market. Three of Montery's founders left three days after the deal closed. Roughly one million of Cisco's shares flowed through the Sequoia funds back into the hands of Cisco executives and directors. By November 1999 Cisco had filed papers with the SEC permitting the Sequoia partnership to sell the Cisco shares in the open market. Don Valentine netted profits of $313,000 in the deal. The Sequoia partnership reaped a 600% return on a $10MM investment, while Cisco investors saw a $517MM write-off.

Sequoia Capital consistently accepted investments from Cisco insiders, subsequently selling start-ups to Cisco at inflated prices. By buying the start-ups Cisco decision makers were buying back their own investments with shareholders' equity. By cashing out of the Cisco shares insiders guaranteed a steep drop in shareholders' equity value.

John Chambers also invested in a Kleiner Perkins fund that owned part of Cerent. Again, Cisco announced acquiring Cerent on August 26, 1999 for 100MM shares worth $6.9B, under much fanfare. The Cerent acquisition netted Mr. Chambers 126,243 Cisco shares through the distribution to Kleiner Perkins. Analysts estimate it may take Cisco two decades to recoup the price paid for Cerent. Prior to the acquisition Cerent had never been profitable.

Director Conflicts at Qwest Communications International

The board's purpose is to represent shareholders, not themselves, and not the management.[20] Clearly, this has been lost on Cisco's management. Another company whose board members put themselves ahead of shareholders' interests is Qwest. Philip F. Anschutz and Craig Slater, both members of Qwest's board, thought it was legitimate to do a partnership with a venture they owned through Anschutz Investment Company, called Anschutz Digital Media. Mr. Slater, President of Anshutz Investment Company, in a conflict-of-interest between the best interests of Qwest's shareholders, Mr. Anschutz, and himself decided to form the relationship with Qwest. In October 1999 Qwest put up $85MM – payable over nine years – for a 50-50 partnership with Anschutz Investment Co. In June 2000, Qwest took another 25% stake costing $48.2MM. By February 2002 the venture was closed down, costing Qwest $33MM in charges.

This was not the only time Mr. Anschutz conducted self-dealing to enrich himsef; Anschutz Investment Co. sold Qwest Precision Systems, Inc. for $34MM in late 1999. The business was later sold for less than what Qwest paid for it. Charles Elson says both board members were "on two sides of the transaction," prsenting a conflict-of-interest.[28] Over the last three and a half years Mr. Anschutz cashed in on net proceeds (stock sales minus the sales of exercising stock options) of $1.5B and Mr. Slater $18.9MM of Qwest stock.[29] Qwest's board had no interest in representing shareholders. The board's members represented their own self-interests – called self-dealing.

Director Conflicts at Siebel Systems, Inc.

Another interesting conflict-of-interest can be found on Siebel Systems, Inc.'s board. It was recently announced that The Teachers' Retirement System of Lousiana sued Siebel over the unauthorized awarding of stock options to CEO Thomas M. Siebel and non-disclosure of option grants to board members. The suit contends that shareholders never approved some of the grants and the value of the options were not accounted for properly. The suit contends that some of the options were issued at below market prices, so they had intrinsic value, but weren't expensed properly.

One director, Charles R. Schwab, was asked to return some of the "tainted shares."[25] Mr. Schwab is chairman and co-CEO of his own firm – The Charles Schwab Corporation. In 2002 Mr. Schwab netted $11.9MM in Siebel stock sales proceeds. He owns 3.4MM of Siebel shares. All told, in 2002, Siebel insiders netted $104.9MM in Siebel stock sales proceeds. Even though, Siebel's stock was off 83% from the start of 2002 to its October 7, 2002 low, insiders profited handsomely. Mr. Siebel, himself, netted $34.6MM, so much for alignment with shareholders.[22]

Another interesting aspect of this conflict-of-interest story deals with Mr. Schwab's quid-pro-quo relationship with Siebel's customer-relationship management (CRM) software product. Mr. Schwab's company invests heavily in Siebel's CRM software. By Mr. Schwab accepting options from Siebel you have to question his loyalty and duty to his own firm to remain unbiased in choosing the most appropriate CRM software or to have purchased any CRM product, at all, for that matter. Since the bubble, Schwab's stock has swooned roughly 85% from its high. Siebel's CRM product does not integrate well with Schwab's legacy envrionment and in some Schwab environments duplicates functionality from other products. Experts have questioned the viability, efficiency, and true cost benefits achieved through CRM software.[30]

I'm Glad Senator Lieberman, Representative Oxley, and Mr. Doer "Look Out for the Little Guy"

"The test of our progress is whether we provide enough for those who have too little."
Franklin D. Roosevelt

Research done by a compensation expert contends that a little over 80% of all employee stock options over the last ten years went to employees other than the top-5 executives.[31] Kleiner Perkins Caulfield & Byers venture capitalist (VC) John Doer contends that expensing of stock options will prevent millions of rank-and-file workers from sharing in stock-ownership. Representative Michael Oxley says American workers will be harmed in a profound way if we expense stock options. Senator Lieberman is afraid if we curtail stock options a lot of average people will get hurt. "A lot of average people are getting a lot of stock options," he said, and this lets them "buy a house and send their kids to college." Anecdotally and from other research sources, I question the wisdom behind these assertions. A lot of chief executive offecisers (CEOs) will be affected, but the rank-and-file, negligible. And Senator Lieberman, the average people getting hurt are the 94MM investors.

The Evidence Shows the Rank-and-file Don't Benefit

A survey by the National Center for Employee Ownership, found that 80% of all stock options in publicly traded companies are given to managers, and that about 50% go to the most senior executives. The average senior executive gets $512,000 and hourly workers get $8,000.[32]

In another study by the same group, the top-5 executives receive 75%, the next 50 executives get 15%, while all other rank-and-file employees get 10% of all stock options. Only 6.4% of nonexecutive employees in 1999, making less than $75,000, had employee stock options.[33] An EXECUCOMP S&P1500 report claimed that option grants to senior executives as a percentage of total options to all employees was fairly constant, ranging from 27% to 32%.

A study at Rutgers University conducted by Joseph R. Blasi and Douglas L. Kruse looked at 1,500 of the largest American companies from 1992 to 2001. They confirmed that most options go to top executives. Starting in 1992 through 2001, a median 29% of stock options went to the top-5 executives. That was trimmed to 18.2% in 2001.

In traditional companies 30% of all options go to the top-5 executives. Companies distribute the remaining 70% narrowly among executives and managers making up less than 5% of employees at traditional companies. The top-5 executives in traditional companies own 8% and the remaing employees 2% of total equity. In the top-100 high technology companies that trend changes to 14% for the top-5 executives and 19% of total equity for the remaining employees. No question, high technology companies are more egalitarian, but regardless the top-5 make a windfall. From 1997 to 2001, the top-5 executives at the average American company shared $31.6MM in profits from exercising stock options. This figure does not include salary and bonus. In regards to stock options, Dr. Blasi states, "management does not deserve the concentration in them … all of the profits go into the top … hijack the whole American idea of profit sharing." Of the country's 10,000 public companies, only 6% consistently provide options for workers.[5]

From my experience, 30-40% of all options go to the top-5 executives, the next 50-60% to managers managing people and corporate staff, and the rest, maybe 0-15%, to exempt and non-exempt non-management employees. The distribution of options to exempt and non-exempt employees, those making less than $75,000, is minimal, maybe 100 or 200 shares a year, at most. If trade groups are going to make a case for the rank-and-file, companies should disclose the option grant distribution by salary level, because today this information is not made public. The top-5 percentage comes up so often, because it's the only consistent information available across companies found in the annual proxy.

Recently, I noticed an online news item in *ElectronicNews*, titled "Semiconductor Equipment and Materials International (SEMI) Votes No on Expensing of Stock Options." The study represented 31,500 employees and companies with combined annual sales of $13B. SEMI wouldn't disclose how many or which companies were included in the survey, which takes away from the study's value. The article said, "74% of industry employees receive stock options and that more than 86% of the total options granted go to rank-and-file employees, rather than C-level executives."[34] I still don't know what C-level executives are; after calling SEMI, a representative indicated that 86% of employees included all employees, except the top-5 executives. SEMI couldn't tell me how many options went to each salary class or what proportion went to managers. Evidently, SEMI has a very loose definition of rank-and-file, which includes everyone after the top-5 executives. On SEMI's web site a similar press release stated, "86% of the total options granted go to rank-and-file employees, rather than the top members of executive management."[35]

The National Center for Employee Ownership concludes that 10MM U.S. employees receive stock options. Other authors quote a 15MM estimate. Couple this with the fact that 58 million investors have 401Ks[36] and roughly 94MM Americans own stock. Blasi and Kruse estimates that only 2% of the U.S. work force gets options every year. Corporate America grants less than 1% of its shares to regular workers.[5] Why are we sacrificing fair, accurate, and transparent accounting for the sake of a privileged few? Another author even proclaims that the 10 million receiving options figure is inflated. The 10 million refers to the number of workers with options in their accounts. I assume accounts refers to brokerage accounts. He contends that only 3MM employees received stock options in 2001.[37] I wouldn't call this a good reflection of the rank-and-file or a good reason to maintain perverse accounting. Sacrifice fair option expensing accounting, for the benefit of 3MM employees. This is absurd. The rank-and-file don't participate!

The Social Inequities of Stock Options

Senator Lieberman, Representative Oxley, and Mr. Doer, needless to say, the rank-and-file don't participate. Yes, there are some companies like Intel and Cisco, who give options to a large proportion of their employees. But how can you explain executive pay rising 535% in the 1990s, while the average worker's pay rose 32%?[38] Kevin Phillips, author of *Wealth and Democracy: A Political History of the American Rich*, cites that in the '60's and '70's, executives' pay, compared to the average worker's pay, was about 25 and 40 to 1, respectively. In 2000 that went to roughly 460-470 to 1. During this time non-supervisory worker's pay declined and workers' pay in the middle went nowhere. He also cites that the 10 highest paid CEOs in 1980-1981 made $3.4MM, in 1988 $22MM, and in 2000 that leaped to $155MM. Over this same period stock options have become more prevalent, rising two to three fold over the last decade.

According to Paul Krugman's *New York Times* magazine article, "For Richer – How the permissive capitalism of the boom destroyed American equality," there is no comparison between what executives earned a generation ago and what they are paid today. The average American's salary rose from $32.5M (thousand) in 1970 to $35.9M in 1999, a 10% increase over 29 years. The average annual compensation of the top-100 CEOs went from $1.3MM in 1970 – 39 times the pay of an average worker – to $37.5MM in 1999 – 1,000 times the pay of the average worker. The Congressional Budget Office (CBO) found that the share of income going to families in the middle has risen 10% from 1979 through 1997, while families in the top-1% rose 157%. Of the top-1%, 60% of the gains have gone to families making over $790M, the CEO class or 0.1% of the population. The disparity in income has risen to levels that are counterproductive and clearly our politicians have reacted by serving the interests of the privileged, while ignoring the aspirations of the investor class. A major reason for this disparity is the growing use of stock options.

Another interesting fact is that the top-10% of taxpayers starts at the $81,000 income level. If you remember, very few employees making less than $75,000 get stock options, maybe 0-15% of an option grant. This is generous. We are sacrificing the earning power of 90% of the taxpayers for the benefit of the upper-10% of the income spectrum. Again, I agree with Phil Angelides: "this is an equity transfer" from 94MM shareholders to the upper-echelons of the income spectrum.

I've already cited that ~80% of executive pay comes from stock options. In 2000 shareholders lost 12%, based on the Wilshire 5000. CEOs, on average, received a 36% increase in salary, bonus, and restricted stock – not including stock options. Salaried employees received a 4% raise and hourly workers a 3% raise.[7] The catalyst for the rise in executive pay was stock options.

William J. McDonnough President of the Federal Reserve Bank of New York, gave the following warning to corporate America over its pay levels: "CEOs and their boards should simply reach the conclusion that executive pay is excessive and adjust it to more reasonable and justifiable levels," he said. He derided CEOs for recent pay hikes for setting "terribly bad social policy and perhaps even bad morals."[39] Executive pay is completely out of control and stock options are a major reason why. We must cease this massive wealth transfer from shareholders to senior executives.

Another author, Thomas G. Donlan states, "it's a stupid thing if stock options are reserved for top management, even stupider if top management takes huge numbers of options disproportionate to their salaries, and ultimately ridiculous if the company reprices out-of-the-money options or issues new options with a lower profit point when the company does poorly."[37] I agree. Who will stop Cisco, Ciena, E*Trade, and Siebel Systems from continuing this unseemly practice?

Dr. Blasi exclaims, the people who made money, made it through capital gains. Employees want to participate in profit sharing and capital gains. This cuts across all age groups and political orientations. Workers have digested the fact that their incomes adjusted for inflation over the last two decades has been largely flat. Workers don't want executives to hijack the idea of capital ownership.

To keep the expensing of stock options out of Sarbanes-Oxley, Kleiner Perkins' venture capitalist John Doer, a leading Democratic donor, helped kill the stock options restrictions in the Senate. Mr. Doer called Senator Daschle to voice his anti-shareholder views before the vote.[40] Representative Oxley was quoted as saying, "not just money, but character, counts in America," yet the Representative is the recipient of large donations from the financial services industry. He lines up with the industry, so executives get a windfall at the expense of investors. Of course, the industry doesn't want to stop the exemption on stock options, so neither does Mr. Oxley. According to the Federal Election Commission filings, 74% of Mr. Oxley's campaign contribution receipts came from outside Ohio.[41]

Many unemployed workers in Silicon Valley are working without pay or health benefits, but accepting stock options as compensation. These are highly skilled workers accepting equity only jobs, because it beats waiting at home for the phone call that never comes. Many are simultaneously receiving unemployment benefits. State officials acknowledge that working for equity may jeopardize their unemployment benefits and the company may be violating state or federal labor laws. All employees are due at least the minimum wage. However, the state admits it has no way to track whose being paid in stock options. It's no wonder venture capitalists fight to maintain the status quo, stock options are not deemed compensation, so in tough times they get workers for free. Kirthi Kalyanam, director of e-business initiatives at Santa Clara University's Leavey School of Business says, "it's hard for me to see why a good company would ever engage in these kind of things." Companies that don't pay, don't value a worker's labor or time.[42]

Bernard Baruch said it best, "instead of trying to judge a nation by some ideological label like "capitalism," "socialism," or some other "ism," I would suggest a different measure – namely, the progress a nation is making in bettering the living conditions of its own people." The lack of accounting for stock options is having harmful effects on 94MM investors' livelihoods, instead of catering to the upper-echelons of society. How about doing something for the hard working investors? The system has failed investors.

Cometh the Tax Man or, When It Comes to Stock Options, Santa Claus

Another interesting benefit afforded corporations from stock options is the ability to improve "cash flow from operations (CFO)" with the tax benefits from stock options. Note that employees pay taxes on stock options when they exercise them, companies don't have to, which provides a tax credit. Most option grants, over 90%, are issued "at-the-money," qualifying as a "fixed" option, thus no expense or tax deduction – zero cost. The exercise price equals the "at-the-money" option, so upon exercise the issuer gets back his cost. Employee stock option accounting rules are described in APB Opinion No. 25, Accounting for Stock Issued to Employees. To find out more about the technical aspects of APB Opinion No. 25, I recommend Attachment 3, Peter Clapman TIAA-CREF comments to IASB's Sir David Tweedie, located on the CalPERS web site: April 15, 2002 Investment Committee Meeting, 6. Public Markets, B. Corporate Governance and Financial Market Reforms.

Many high technology companies have benefited immensely from the 2000 stock market bubble. In 2000, the S&P 500 reported an estimated total tax benefit from stock option exercise of $34.7B. The IT sector accounted for $19.4B of that figure or 56% of all stock option tax benefits.[4]

In many ways managing equity became more important to buttressing the financial statements than manufacturing products for many technology companies. The tax treatment of employee stock options has had a significant affect on cash flow, termed a subsidy by Jack Cieselski. Extracting three line items from Cisco's Q1 cash flow statement for the last four years provides the following insights:

Cisco Systems, Inc. Cash Flow Analysis

$Millions of dollars	Q199 10/24/98	Q100 10/30/99	Q101 10/28/00	Q102 10/28/01
Net Income	$518	$415	$798	($268)
Tax benefits from employee stock options	41	381	985	43
Cash flow from operations (CFO)	850	1,132	1,363	1,384
Tax credit as a percent of CFO	5%	34%	72%	3%

In Q101, among the heydays of the boom, employee stock options' tax credit exceeds the cash generated from producing networking equipment. The tax credit or non-cash adjustment in that quarter, which is a positive adjustment to CFO, accounts for roughly ¾'s of that quarter's CFO. An over-valued stock generates a tax benefit that distorts CFO, and investors believe the operation is humming along, when in reality, cash generation from operations has collapsed.

Besides the large CFO distortion, it makes no sense to be receiving a tax credit, when the company isn't realizing a concomitant compensation expense. Senator John McCain said it best: "no other type of compensation gets treated as an expense for tax purposes, without also being treated as an expense on the company books. If companies do not want to fully disclose on their books how much they are compensating their employees, then they should not be able to claim a tax benefit for it." Simply put, stock options should be treated the same way for both accounting and tax purposes. Cisco is not alone in this distortion; many other technology firms suffer from the same malady, resulting in reduced investor confidence in the soundness of a firm's business model.

The current tax rules need to change, as they distort CFO. Employees are rewarded with a tax on the stock option exercise capital gain, while companies reap BIG tax deductions, to keep the egregious lining of executives' pockets going. In a perfect world, the expensed valuation calculated for the stock option on the income statement would become a tax deduction and the employee would pay the captial gain above the exercise price when cashed in.[43]

Stock Options are the Catalyst for the Recent Corporate Scandals

Another problem with stock options is that executives may benefit personally by higher revenue or EPS numbers. Stock options are at the heart and the catalyst for Enron, Xerox, Qwest, Global Crossing, WorldCom, and many other Wall Street scandals. Since some stock options are tied to performance, enhancing performance provides a powerful incentive to misrepresent a company's results. Stock options encourage managers to take on excessive risk, hoping for that big option pay-off, and increasing the probability of destroying long-term shareholder value. Sorry Mr. Doer and Mr. Grove, but stock options are at the heart of the Enron debacle and many others.

Enron management decided to transact the Nigerian barge deal and a series of complex gas and power trades with Merrill Lynch at the end of 1999, so Enron could make its Q499 EPS target. In the barge deal, Merrill agreed to buy three barges that operated as floating power stations from Enron for $7MM in equity and $21MM in debt. Enron executives assured Merrill that Enron would buy the barges back in six months at a fixed rate of return for Merrill.[44] The gas and energy trading deal was five times larger than the Nigerian barge deal. The idea in that deal was to sell contracts tied to their own production way into the future, but book the profits up-front, even though no cash traded hands. Essentially, Enron and Merrill swapped energy contracts over four years, but no cash ever changed hands. Both deals combined permitted Enron to book $60MM in profits. On January 18, 2000, Enron announced $259MM in Q499 profits or $0.31, matching analysts' consensus expectations. Without the $60MM boost to profits, EPS would have fallen short, at $0.24.

Chuck Hill of First Call indicated that if Enron had missed by $0.07, "This would have creamed the stock." After the announcement the stock rose 27%. Former Enron executives admitted, "This was absolutely a sham transaction, and it was an 11th hour deal ... we did this to get 1999 earnings." Two weeks after the earnings announcements 20 Enron executives and directors sold $82.6MM in stock.[45] Don't tell me that the excessive use of stock options wasn't the impetus for Enron's corrupt, shameful corporate behavior. The mastermind behind this deal agreed, Chairman and Chief Executive of Enron North America. He may have felt so ashamed that it led to his demise earlier this year – his name -- J. Clifford Baxter.

In a response to Senator Barbara Boxer's query about Enron's excessive use of stock options during the February 2002 Enron Senate hearings, Jeff Skilling, former Enron CEO, couldn't help but get a dig in, "I think FASB tried to change that, and you introduced legislation in 1994 to keep that exemption."[46] Mr. Skilling is a true expert and made roughly $89MM through stock options. He was only out done by Chairman Kenneth Lay, who cashed in on $247MM by exercising stock options. Senator Boxer has been one of the staunchest opponents of option accounting reform.

By issuing $600MM in stock options from 1996 through 2000 Enron eliminated more than $625MM in taxes that the company owed to the government.[47] Which allowed it to receive $381MM more in tax rebates than it paid in corporate income taxes.[48]

Stock options provide a powerful incentive to cheat and there can be no real reform without the expensing of stock options. By expensing options, executive pay would become more transparent; cooking the books would not be as tempting; and managers would be less inclined to take on excessive risk.[49]

The Elegance of the Black-Scholes Options Pricing Model

Black-Scholes takes into account the stock's price when the option is granted, time remaining before an option expires, interest rate, and stock's record of volatility.

A drawback expressed by detractors of expensing stock options is the difficulty in forecasting the volatility, thus the future option value. Volatility is tough to determine, because all you have to go by is historical volatility, which, of course, may not be reflective of the future. However, the originator of the Black-Scholes option pricing model, Myron Scholes, confesses, "The volatility over the longer term provides a better estimate of volatility than the implied volatility of shorter-dated options ... Uncertainties, changing expectations, discount rates and liquidity premiums might be more settled over a longer horizon." The options value will be very sensitive to the volatility; the greater the volatility, the greater the option's price. Black-Scholes may have its drawbacks, but it is the best model available that has worked for option traders since 1973.[50]

Even though there may be drawbacks to Black-Scholes, volatility is not one of them. The Black-Scholes is a time tested elegant model; if a company wants the Black-Scholes to be less volatile it must work to keep its stock price less volatile. Technology companies are not good at diversifying their revenue stream, so they have a difficult time smoothing performance. Another solution is to use the binomial option pricing model or have investment banks submit bids on the value of the options. The prices can then be averaged to determine the option's price. This method was suggested by Warren Buffett to determine Coca-Cola Company's employee stock options.[51] I would think the larger technology concerns could benefit from this method.

Other authors state Black-Scholes undermines transparency and exaggerates what options really cost.[52] Yes, the Black-Scholes is rigorous, it's not a formula that you commit to memory. But it is time tested and programs make it easy to fill in the relevent parameters and generate a price. As an investor, I want the best possible information on a company in a timely manner. Black-Scholes creates a precise and reliable expense number for financial statements. By expensing options I know immediately the impact on EPS as reflected on the current share price. The higher the share price, the higher the cost of the option, the greater the compensation cost, and the greater liklihood that this action will reduce my investment's value.

The following chart shows the Black-Scholes call option price, along with other relevant parameters from five technology companies. All options are JAN 2005 LEAPS, with 828 days until expiration and used the expected dividend, risk free rate, and volatility parameters supplied in each firm's 10K:

Black-Scholes Option Pricing Model Results

Name	Stock Price	Exercise Price	Volatility	Call Ask Price	Black-Scholes Price	Relationship to the Ask
Cisco Systems, Inc.	$10.99	$12.50	0.475	$3.50	$2.98	(14.9%) below the Ask
Intel Corporation	$16.52	$20.00	0.766	$4.40	$6.78	54.1% above the Ask
Oracle Corporation	$9.69	$12.50	0.57	$2.75	$2.70	(1.9%) below the Ask
Hewlett-Packard Corp.	$13.50	$20.00	0.39	$2.05	$1.66	(19.0%) below the Ask
Microsoft Corp.	$52.29	$60.00	0.39	$12.20	$11.77	(3.5%) below the Ask

Intuitively, if you trade options you know that the market makers always negotiate the highest "ask" price possible, so it's not surprising that the Black-Scholes under-states the market price. I don't understand where the opponents to the expensing of stock options get the notion that Black-Scholes over-states the option price; in most cases it will under-state market values, as I have demonstrated above. (Note I just randomly chose five TechNet companies.) Mark Schwartz, CIBC Oppenheimer's chief option strategist, says, "we know a great number of options tend to be over-priced or under-priced—yielding opportunities that traders and arbitrageurs look to exploit .... companies could end up overstating or understating their earnings."

Intel was the only firm that registered a Black-Scholes price exceeding the "ask" price in my analysis, which was almost exclusively due to its high volatility -- 34% greater than the next highest volatility in the sample. If you reduce the volatility by 33.8%, you get a volatility of 0.507 and the Black-Scholes call option price equals the "ask" price. In 2001 Dell Computer issued options worth $13.04, when the stock traded at $23.24, or 56% of the value of the stock. Dell exhibits very high volatility; in contrast, Phillip Morris issued options whose value was worth 23% of its stock. Technology companies will take the bigger options expensing hit, because their stocks are more volatile.[43]

George B. Paulin, president of Frederic W. Cook & Company, a leading executive pay consultant, spoke to the CalPERS board on June 17, 2002 and made the following statement in October 2002: "The fact is that Black-Scholes values are too high," he said. "No investor would buy an option in the open market at Black-Scholes values."[53] Mr. Paulin, if I could buy Cisco or Hewlett-Packard call options at the Black-Scholes price, I would do it all day long, subsequently arbitraging my position, and wouldn't have to work my day job.

Sorry, Mr. Paulin, but the Black-Scholes model works and it works well.

Another interesting development occurred when TechNet member Siebel Systems decided to buy back employee stock options at a price of $1.85 with an exercise price above $40.00. In 2000 Siebel had 41.3% of options outstanding compared to shares outstanding, the largest percentage of options to shares outstanding in the S&P 500.[4] Even though CEO Tom Siebel contends the Black-Scholes model doesn't work, he decided to use the model to determine the average option price. If employees take advantage of the program, Siebel will buy back options on 32MM shares or 13% of the outstanding shares with exercise prices up to $142.61. Who says Black-Scholes is irrelevant?[54]

The Fallacies: Dilution Provides Enough Data , the Treasury Stock Method Results in a Wash, and Stock Options Are Necessary for a Competitive Economy

Dilution Provides Enough Data

The option expense tells me how much management really costs; by only providing the diluted share count the firm grossly overstates earnings. There is no virtue in just diluting the share count, no accuracy -- it's a gross exaggeration. Without expensing options, earnings don't show the purchase cost of exercised stock option shares. These shares are not free, they just don't materialize. To get the shares, the firm must buy them, accounting for them through the "Treasury Stock Method," buying them back with real cash, i.e., in the equity market. This transaction results in a credit or deduction to the cash account. Buying stock costs the firm real money and leaving the option expense out of the EPS calculation leaves a gross over-stated earnings distortion.

Another problem with diluted share count is that the figure doesn't capture all the options outstanding; out of the money options are excluded, therefore you're not seeing the full dilution. As shown below, these out of the money options can have material effects on shareholder value after they eclipse the exercise price. You won't know their effect, until it's too late. Again, the IT sector leads the pact, with roughly 36% of the under-water options outstanding of all aggregate S&P 100 companies.[9]

S&P 100 Diluted EPS Number Does Not Fully Capture Claim on Future Earnings

($MMs)	Options Granted 1999	2000	2001	Options Outstanding 2001	Number of Options Included in Diluted EPS 2001
Information tech.	828	1,534	1,396	4,641	755
Financials	472	512	480	1,969	469
Consumer discret.	254	263	451	1,758	122
Health care	266	247	250	1,306	374
Consumer staples	175	198	204	876	294
Telecoms svcs.	148	248	210	849	50
Industrials	162	146	166	843	216
Energy	56	46	44	326	83
Materials	79	77	66	268	13
Utilities	27	39	77	172	37
Aggregate S&P 100	2,467	3,310	3,344	12,922	2,413

Source: R.G. Associates, Moody‘s

If for some reason the firm has non-distributed shares, never before in the hands of shareholders, then the firm has an opportunity cost. Instead of distributing the shares to management upon option exercise, the shares could be sold to the public for working capital use or capital expenditures. Management could use the shares as currency to acquire another company, give a stock dividend, bolster a stock purchase plan, or buy back debt. The shares used for stock option exercise have value; they can be used in many ways to increase shareholder value other than giving them to the option exercisers. Stock options are a valuable limited resource, to be issued only after exercising extreme discretion.

Management will expect this same compensation in the future. I want to know how much management is getting paid now and how much to expect in the future through the disclosure of the option's cost.

The Treasury Stock Method Results in a Wash

Some proponents of exempting the expensing of stock options contend that the stock options program creates a consistent source of cash flow; cash goes out to purchase more shares for the program, but comes back in when the options are exercised at the strike price, so you shouldn't account for the transaction. In other words, it‘s a wash. Unfortunately, the falacy in this argument is that the cash going out is not the same as that coming in. By definition, individuals only execute their option when the stock's price exceeds the exercise price; since the firm only receives the value up to the exercise price, the firm never recoups the full value of purchasing the shares in the equity market. At times, this discrepancy is substantial. In 2000 Jack Ciesielski notes that S&P 500 firms took in $45.2B in options exercised, but gave away $284B worth of options granted.[4]

Moody's has concluded that the use of financial leverage by issuers to acquire their stock in the open market, offsetting the dilutive effects of exercised options, can have negative consequences on their credit profile. On average, it costs S&P 500 firms roughly five times the amount of proceeds from the exercise of stock options to provide the shares due the employee.[9]

S&P 500 Composite – Financing Costs of Options in $Bs

	1997	1998	1999	2000	2001	Average
Proceeds from the exercise of options	$27.1	$32.0	$36.8	$44.4	$40.7	$36.2
Fair value of shares issued	91.8	125.3	166.3	278.0	236.9	179.6
Financing cost	64.7	93.3	129.5	233.6	196.2	143.5
Ratio of shares issued to proceeds	3.4	3.9	4.5	6.3	5.8	4.8

Source: R.G. Associates

A matter of fact: EDS Corporation, Microsoft Corporation, Dell Computer Corporation, along with many other technology and non-technology companies, decided to mitigate the cost of buying shares for the exercisers of option grants. They accomplish this by writing puts in the hope the underlying share price rises, so they keep the premium and the option expires worthless. The premium helps the firm offset its share-repurchase cost. A number of puts are sold generating a premium to anticipate the cost of the shares beyond the option exercise price. A put gives the buyer the right to sell shares to the put writer at the set strike price. Sometimes the cost to the put writer can be substantial.

Unfortunately, on September 19, 2002, EDS Corporation had to fork-over $225MM to buy 3.7MM shares to cover exercisers of the puts they sold at a $0.75 premium. The put strike price was over $60.00 per share, while the shares in the market traded for ~$15.00. The put options were sold to help purchase 2.5MM shares of its own stock at an average locked in price of $62.90.[55] If the stock option process was a cash flow neutral event then companies issuing stock options would not go through the trouble to hedge their exposure. The hedge was a gamble the stock would rise. EDS hoped to reduce the cost of its employee stock option program. There is risk exposure when employees exercise options and it reduces cash. EDS had to pay above market prices to buy back shares to close the option position.

Dell has spent nearly $2B in above market prices to repurchase shares required by its put contracts. It has paid investment banks an average of $44 a share to purchase shares that have traded from $16 to $33 a share.[56]

The accounting rules are very lax when companies buy and sell options on their own stock. If the company were buying or selling options in another company's stock then the put's value would have to be adjusted each quarter. When companies deal with their own stock, they don't have to disclose the transaction, a driving force for conducting these risky transactions.

Stock Options Are Necessary for a Competitive Economy

Many proponents of exempting the expensing of stock options exclaim, we need the incentive accompanying stock options to remain competitive in a global economy and retain our employees. However, individuals working for start-ups, point out, their firms focus too much on making sales and bringing in deals, rather than building the company's inftrastructure to flourish for the long-term. The company's embryonic infrastructure thwarts the company from supporting sales. Roy Satterthwaite, Vice President and General Manager, at Commerce One, Inc. said, "it was all a mad rush for the next customer sale, versus focusing on making the previous customer transactions successful." Employee stock options cause firm's to focus on the short-term.

In regards to his stock options, "you were really only required to look good at a certain point in time, and as you rose with the rising tide of the market, you could cash out." The options, he says, "motivated us to a selfish, short-term view," as opposed to the detailed-work of building an infrastructure. "They did not create what I believe shareholders want, which is long-term value. In many ways, they were a house of cards."[57]

Top employees are enticed to job-hop by stock-options. This is an up-the-ante problem. By expensing stock options we can make the ante that much more costly, possibly reducing job-hopping.

Other Reasons Why the Expensing of Stock Options Is Coming

Expensing of stock options is a first and necessary step; it's not the end-all solution, we must strengthen the current corporate securities laws and adopt true transparent accounting with all costs accounted for. According to Mercer Human Resources Consulting, a unit of Marshal & McLennan Cos., roughly 90% of the 200 most valuable companies say accounting change is coming – from a study released September 2002.

CalPERS developed a short three-question survey to gauge investor attitude toward the expensing of stock options. A total of 632 Institutional Investors (9.3%), Individual Investors (46%), Academics (15%), Journalists (4%), and Others (15%) completed the survey. Results of the survey show 79% of the respondents feel that change in accounting rules requiring companies to expense the cost of stock options would not confuse investors and 80% of the respondents favor expensing stock options.

Even Computer Associates International, Inc. announced it would start expensing employee stock options in April 2003. Computer Associates has had its corporate governance critics in the past, but this announcement makes it a unique advocate of transparent accounting among high-tek companies. Also, my compliments to the technology analysts at Friedman, Billings, Ramsey, & Co., Inc. and the capital goods analysts at Deutsche Bank AG for their endorsement of expensing employee stock options, along with Level III Communications, Inc.

Standard & Poor's recently announced that it would include the affect of options in the returns of its indexes and when it calculates corporate earnings. Moody's will analytically take stock option costs into consideration when evaluating the quality and consistency of an issuer's earnings and cash flow. Roughly, 150 companies have announced they will support the expensing of stock options. Twenty-one of those firms are members of the Financial Services Forum.

The expensing of stock options will come either through the adoption of International Accounting Standards Board (IASB) or de facto. A draft IASB rule was released late in July of 2002 which will force most of the 15 nation European Union's (EU) 6,000 publicly traded companies to expense options by January of 2005, as they are granted. The switch to expensing will be mandatory. Australian companies will convert to the IASB standards. The total value of an option will be expensed over its lifetime; according to IASB, "you are valuing the right."[3] The Europeans espouse a more egalitarian philosophy on compensation than their Silicon Valley counterparts. We can learn something here.

Unfortunately, options are not completely aligned with the interests of shareholders. When the stock price drops, investors take it directly in the pocket, while option holders can always reprice or issue new options. With an option the potential for loss is small; at worst the option becomes worthless, but the gain may be tremendous. Option holders don't take a realized loss; if they didn't exercise they've made no cash investment, unlike shareholders. You must pay real cash to become an owner. Berkshire Hathaways Inc.'s CEO Warren Buffett has an interesting story concerning the attitude of CEOs towards owners: "A gorgeous woman slinks up to a CEO at a party and through moist lips purrs, "I'll do anything – anything – you want. Just tell me what you would like." With no hesitation he replies, "Reprice my options."[58]

Management may even see it advantageous to keep the stock price low until new options are priced. By canceling options and waiting six months and one day to issue new options, management avoids having to claim the value of the option as an expense, so it gets a low priced option grant. As a shareholder you'll have to wait months to figure out the re-pricing scheme.[59] Ciena, Cisco, E*Trade, and Siebel have abused re-pricing or replacing options.

Janet Pegg, at Bear Stearns, provides a nice explanation of the dilemma faced by investors trying to evaluate two companies. Consider two similar companies, one paying its workers in cash, and another that pays lower salaries but makes up the difference with stock options. Even though the two are otherwise alike, the company granting options appears more profitable. The company granting stock options distorts its profits, because the profits should be the same.[48]

Researchers from the University of Pennsylvania have concluded that companies improve their performance if they include equity in executive compensation packages, but there is a point of diminishing returns. Over a threshold, CEOs owning too much equity become too risk averse and their companies lose their competitive edge.[60]

The Blasi and Kruse study demonstrated that companies dispensing significantly larger-than-average option grants to their top-5 executives produced decidedly lower total returns to shareholders than those dispensing far fewer options. According to Blasi, their study "strongly suggests that executive excess in stock options did not help total shareholder return over the entire decade."[61] The top quartile, top 375, of the study granting 40.8% or more of all options to the top-5 returned shareholders 22.5%, while the bottom quartile providing fewer than 19% of the options to the top-5 returned 31.3%. The greater the option grant to the top-5, above the mean, the worse shareholder's return. The capital markets system suffers from a compromised system of corporate governance. Other studies have also concluded that increasing equity ownership to middle-level managers has a greater impact on corporate performance than to top-tier executives.

A number of studies show options do not raise market returns. Dean R. Dalton, the dean of Indiana University's Kelley School of Business, says the amount of equity executives' own does not affect their company's performance. As a matter of fact he says, "There's no relationship whatsoever." Mr. Dalton's study, co-written with four other authors, combines more than 200 studies with 30 years of data.[62] It was surmised that the strength of the economy and the long-term health of a company determine a company's results, rather than the executives.

Another researcher, Jack Ciesielski, tested the theory that firms with high degrees of options make better returns than those without. He found that 55% of option-heavy firms beat the market; but 32% of option-light firms beat the market as well. His results offered no evidence that heavy option usage itself was a determining factor in strong long-term performance.[4]

Restricting the Selling of Stock Options to Avoid Inequities – Waiting Period

The inefficient and inequitable access to information by corporate executives undermines shareholder confidence. To improve that confidence, we should follow the advice from Senator John McCain and Henry Paulson of Goldman Sachs: directors and executive officers should be restricted from selling their holdings, except to cover income taxes, in company stock while serving in that company.[63] Insiders have an unfair advantage under the current unrestricted selling environment. For example, Oracle's CEO, Lawrence J. Ellison, sold over 51MM shares in January of 2001 (note, I've seen higher numbers when including the period prior to January), before warning investors that Oracle Corporation would not make Q301 guidance, ending February 2001. At the time, the stock was trading above $30.00; it never recovered and slid to under $10.00 in May 2002, roughly a 70% decline. Did Mr. Ellison know something that shareholders didn't? Is Mr. Ellison not an insider? This shows utter disregard for his investors. For 2001 Mr. Ellison pulled in $706MM from exercising stock options.[2] Mr. Ellison received the shares in June 1999, when Oracle was trading at $6.00 a share. He agreed to trade in four years of salary and bonus for 10MM in options.

In 1999 Mr. Ellison already owned 24% of Oracle or 344MM shares. You have to question why Mr. Ellison needed another equity incentive. Is this using common sense? Do investors or employees holding option grants really need more dilution from Mr. Ellison? For there to be any incentive, he would have to have an exorbitant grant. The only incentive Mr. Ellison has is to diversify and sell at the first opportunity. After the original 10MM shares split a few times, he ended up with 40MM shares. When Mr. Ellison sells, shareholders feel the pain.[64]

Insiders have too much of an advantage over shareholders and make plenty of take home compensation and perks without selling stock option acquired shares.

The SEC should repeal the 1991 rule that allows executives to cash in stock options immediately without a waiting period, i.e., automatic selling. A waiting period is needed, because CEOs of small companies have a tendency to sell their recently exercised shares shortly before their stock declines.[65] Manugistics is a good example of this phenomenon; in 2001 CEO Craig Owens sold 400,000 shares through automatic selling.

David Rickey, CEO of Applied Micro Circuits Corporation (AMCC), is another example of someone who abused the waiting period. AMCC's shares began trading in November 1997. Mr. Rickey sold $24MM in stock in 1999 and another 820,000 shares in 2000. The options to gain these shares had another eight to nine years to exercise; yet Mr. Rickey decided to exercise early and sell immediately. It's estimated that Mr. Rickey sold more than 99% of his stake and made $170MM. The stock plummeted 98% from September 29, 2000 through October 4, 2002. This is not aligning with long-term shareholders. On March 2, 2001, during an interview with Maria Bartiromo on CNBC, Mr. Rickey exclaimed, "I am very bullish about the company … I dare you not to own my stock." While Mr. Rickey was getting out, investors were buying his story. Again, there needs to be a waiting period to align management with shareholders.[66]

Restricting stock option exercised share sales creates an incentive to make the company successful in the long-run and think of the soothing affect this would have on stock price volatility.

Conclusion

Stock options are compensation, they're salary, and they're a credit on taxes, so they should be expensed. Not expensing stock options creates erroneous earnings by leaving out a true expense. Exempting, the expensing of stock options, distorts the market's perception of option heavy entities, causing a mis-allocation of capital flow and eventually causing an industry glut. Could it be that the option heavy sectors, Information Technology and Telecommunications, weren't evaluated properly, that too much capital chased these sectors, and the over-building squeezed out future profits for everyone? Sure, I agree, link pay to performance, but let's account for it. I'm not advocating a ban on employee stock options.

Companies should have incentives to give restricted stock, instead of relying on stock options.

When firms award stock options the exercise price should be indexed, so if the index moves, so does the exercise price. In the current environment, standard stock options give windfalls to executives in a bull market and penalize them in a bear market. From 1997 to 2001, the top-5 executives at the average American company shared $31.6MM in profits from exercising stock options. Too many executives get big rewards for poor performance. If the biggest factor affecting a firm's performance is the economy, then all employees should participate, not just the top-5. The index should be a basket of comparable companies.[67] Insiders have too much of an advantage over shareholders and make plenty of take home compensation and perks without selling stock option acquired shares.

Companies should be required to use incentive-based options, which must be expensed under current accounting rules.[68] Only 16% of the largest U.S. companies have granted performance-based options.

When options are granted they should be priced above the stock's current market price. This is called premium pricing. Frederic Cook & Co. indicates that only 21 of the 250 or 8% of the largest companies now premium-price options. Premium-pricing aligns shareholders' desire for equity growth with management pay.

A line in Cisco's 10K states, "in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of the Company's options." This same line appears in 10Ks from many other companies. Frankly, management doesn't like the model, because it's too accurate. The bottom line, waiting for the footnotes in the 10K is too late to find the extreme EPS damage done by stock options. As an analyst, I need up-to-date data every quarter. I can't wait until the end of the year to discern the EPS damage. Under the current accounting standards, I cannot adequately evaluate companies that do not expense employee stock options. The EPS damage must be made available sooner and more transparently. Currently, the financial statements are not represented accurately or fairly.

Granted, Cisco began including SFAS 123 data in its Q103, ending October 2002, quarterly 10Q footnotes, but I need the data in the income statement and explained during the conference call. Yes, we're going in the right direction. If TechNet believes that the expensing of stock options will thwart innovation and slow down economic growth then give the innovators restricted stock, not options. The expensing of options does not preclude granting options; it just makes it far more equitable to the current non-employee shareholders.

The corruption in the ranks of CEOs and trade groups like TechNet is destroying our capitalist system. Please support corporate accounting reform by endorsing further regulation benefiting investors and with it, swift accounting transparency. William R. Thomas at Capital Southwest Corporation said it best: “the impending takeover of corporate America by self-serving elitist managers may prove to be far more damaging to capitalism than anything Karl Marx could have conceived.”[69]

Stock options provide a powerful incentive to cheat and there can be no real reform without the expensing of stock options.[49]

By expensing stock options we place discipline on management, which should rein in the excessive use of options. The damage to earnings is palpable, this does not come for free, and not expensing options is a gross exaggeration of earnings. An option is NOT FREE.

Recommendations

1. Foremost, we need campaign finance reform to stop Representatives and Senators like Mr. Oxley, Ms. Boxer, Mr. Lieberman, and Mr. Daschle from selling out 94MM shareholders to the special interests of the Securities Industry Association (SIA) and TechNet.

2. Change the way stock options are taxed. Companies should take a tax deduction on the option expense valuation at the time of the grant, or better yet, the moment of vesting -- not when employees exercise -- generating a corporate capital gains tax credit.

3. Stop treating the cash in-flow on employee option exercise tax credit benefit as an operating cash flow.

4. Make derivative transactions on a company’s own stock more transparent. Investors should know more about the selling of put options to hedge employee stock option plans. These transactions should be clearly detailed in the 10Q footnotes: strategy, timing, triggering events, and worst case risk scenarios.

5. Bring back the 1991 rules to restrict the selling of stock by executive management for extended periods of time after exercise or better yet, until they are no longer employed at the company issuing the option grant.

6. Prevent conflicts of interest between board members of companies and the companies that the board decides to acquire. Venture capitalists or investment officers should not be sitting on the board of a company that decides to acquire his investments; that’s a direct conflict-of-interest. A board‘s purpose is to represent the shareholders, not themselves, and not the management.[20] Established companies should not have venture capitalists on the board. Better yet, regulate the venture capital industry and investment management firms to eliminate conflicts of interest.

7. Forbid corporate officers from accepting corporate consulting contracts or benefiting from employment contracts with the company on whose board they sit. Please limit the ability of board members to sell any options they are granted while on the board. When there are supplier or buyer

links between a company and its board members there will be conflicts-of-interest. Stock options to these individuals should be prohibited.

8. If companies do grant stock options, then promote equitable distribution of the stock options based on an employee's pay. Companies should publish the distribution of stock option grants by annual salary. Since distributing options to middle-level managers has the greatest impact on shareholder return, shareholders should know how the company distributes stock options among its workforce. I suggest creating buckets of salary ranges and giving the percentage of options granted to each range, quarterly. Middle class, lower class, and professionals at companies should all participate equitably in stock options, not just executive management. Increasing equity ownership to middle-level managers has a greater impact on corporate performance than top-tier executives.

9. Stop option re-pricing or issuing new options when the company exhibits poor performance for an extended period of time. Set a triggering event, possibly a 30% share price decline. After the trigger hits prohibit new option grants or option repricings for two years or more. Set conditions to preclude options grants when shareholders get burned.

10. Promote indexing options and premium-priced options.

11. Provide incentives for restricted stocks.

12. Don't invest in any company that does not expense stock options and divest in companies that decide not to expense stock options, including all companies with a relationship to TechNet.

13. Develop a professional option pricing and bidding system to certify long-dated, non-traded employee stock options.

14. The leaders of the audit and compensation committees should be independent directors.

15. Provide all stock options in the diluted share count figure, including those with exercise prices below the stock's market price, i.e., the under-water options.

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