Remarks Of

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"Executive Compensation: The Stock Option Dilemma"

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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I. Introduction

I appreciate the opportunity to address this conference as you spend your "afternoon with the SEC." Before I launch into the focus of my remarks today, executive compensation, I wish to spend a few minutes on the issue of social or political shareholder proposals.

II. Social or Political Shareholder Proposals

While I am inclined to believe that social or political public policy issues which lack a strong economic nexus with the company, no matter how attractive the cause, should not be proper subjects for shareholder proposals, the more relevant point is that the Commission's staff should not be in the general business of deciding which social or political public policy issues are to be included in, or omitted from, a particular registrant's proxy materials. Judgments on those issues are, in my view, better left to another forum, such as Congress.

As a path out of this morass, I have earlier recommended that the Commission should consider the following two proposals, in the alternative, or in some combination thereof, as amendments to Exchange Act Rule 14a-8:

1. Limit the subparagraph (c)(5) exclusion to matters that concern a registrant's operations on the basis of the economic percentage tests only, and thereby eliminate the alternative test of "not otherwise significantly related," with the result that shareholder proposals that predominantly pursue a social or political agenda could be excluded provided that the operations which are the subject of the proposal do not meet the economic percentage tests; and/or
2. The Commission could provide a separate exclusion for proposals that promote social or political causes.

By limiting the staff's ability to review proposals that predominantly involve a social or political agenda and that lack a strong economic nexus with the registrant, the Commission will appropriately reestablish that Rule 14a-8 is primarily designed for disclosure purposes. Accordingly, Rule 14a-8 would be used as a corporate governance device rather than as a tool to champion good corporate citizenry through shareholder democracy.

I wish to mention this subject briefly because two recent conflicting court decisions rendered by two different judges, both from the United States District Court for the Southern District of

New York, concerning the same basic predominantly social or political shareholder proposal only add to the confusion on this subject which has already existed.[1] I hope that the Commission will use the staff review of its proxy rules as an opportunity to achieve some much needed reform in the shareholder proposal area.

III. Executive Compensation

Moving to the focus of my remarks today, which is on executive compensation, and more particularly, on what should be done regarding stock options, you need not be told that there is a groundswell of public interest in executive compensation. The print media has been focusing significant attention on CEOs that are perceived to be overpaid. Shareholder groups and institutional investors are pressing for better disclosure of executive compensation. Legislation has been introduced in Congress on this subject, and the Commission has undertaken a project to propose an improved system for disclosure. As corporate counsel, you undoubtedly are concerned about what this may mean for your companies.

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1 New York City Employees Retirement System v. Brunswick Corp., 92 Civ. 1714 (S.D.N.Y. April 21, 1992); New York City Employees Retirement System v. Dole Food Co., 92 Cir. 2551 (S.D.N.Y. April 24, 1992).

First, let me put your minds to rest on one issue. The Commission is not interested in dictating the level of pay for corporate executive officers. That is the job of the board of directors, as elected by shareholders. The Commission's interest and jurisdiction in this area is limited to full and fair disclosure. An informed shareholder is better able to exercise his or her voting rights with respect to the election of directors. Likewise, an informed investor is better able to determine the true value of a company. Thus, any Commission proposals will be disclosure-based.

Having said that, let me fray your nerves a bit by reminding you that the Commission also has a significant role in overseeing the accounting treatment of public companies. There have been suggestions, including legislation introduced by Senator Levin, that the Commission should modify the accounting treatment for stock options by requiring that a present value expense be determined at the time of option grant for purposes of inclusion in the income statement. The argument is that stock options represent a form of valuable "stealth compensation" that is neither properly disclosed nor properly accounted for as a cost to a company.

IV. Stock Option Mechanics

The use of stock options as a component of executive compensation has both detractors and supporters. The detractors argue that stock options cost shareholders by diluting their holdings, cost nothing to executives, and give executives no downside risk, and also argue that the value of stock options to executives is not properly reflected or measured in the company's financial statements. Supporters of stock option use argue that options provide long-term incentives for executives and cost the company little, if anything, to award. Perhaps both are correct.

The right to purchase securities at a fixed price is a valuable right. The fact that there are numerous national securities exchanges trading options supports that observation. A major issue to be resolved, however, is how much are executive stock options worth.

Executive stock options differ from exchange-traded options in two regards. First, executive stock options generally have a longer life than exchange-traded options. Secondly, and more importantly, executive stock options are not transferable generally. It is this latter feature that has given rise to much of

the controversy surrounding option valuation. While various formulas can adjust the value of an exchange-traded option to reflect a different period until expiration, there appears to be no consensus as to what discount is appropriate for a non-transferable option.

V. Stock Option Valuation For Disclosure Purposes

There are advocates of different types of option valuation formulae. Although most of you have heard of the now famous Black-Scholes model, there are not many people who have mastered it; and I am not one of them. It is a complex formula that, in its simplest terms, measures the volatility of the underlying common stock price and compares this volatility against expected rates of return over the life of the option. While computer software is available undoubtedly to calculate the precise value, critics of the model argue that important components such as the risk-free rate of return and the volatility are susceptible to disagreement, which may lead to diverse valuations of similar options. More importantly, they argue that the model is only useful for exchange-traded options, which are freely transferable. Other valuation models have been similarly criticized.

Given that it is no easy matter to value options, should the Commission require its registrants to value options at the time of grant for the purposes of disclosure to the shareholders in the proxy statement? It seems to me that the costs of such a requirement may outweigh the benefits to shareholders. However, I do favor improved disclosure concerning grants and exercises of executive stock options because I believe that enhanced disclosure is the key to resolving the present stock option dilemma. Improved disclosure does not necessarily mean more disclosure but often disclosure which is simpler, clearer and more coherent.

The primary advantage of requiring registrants to disclose a present value for stock options is that such present value will assist financial analysts and compensation consultants in comparing all forms of executive compensation between and among companies. The primary disadvantage of option valuation is that it may mislead shareholders. In addition, the requirement may prove burdensome to small emerging growth companies.

Shareholders are not protected by regulations that provide a significant opportunity for either deception or manipulation of material information. Requiring registrants to generate and

disclose a present value for executive stock options at the time of grant, using a prescribed formula, may create such an opportunity. It would of course depend on the formula used, but a Black-Scholes model could yield significantly different values for the same option grant if registrants were given the necessary flexibility to make assumptions about key components of the formula. This range in values is not likely to achieve the goal of aiding comparability of executive pay between companies. An inflexible formula, on the other hand, is unlikely to be workable, and likely to result in a flood of interpretive requests.

Another problem with valuation at the time of grant is that executive stock options are unique. Unlike unrestricted stock grants, they generally cannot be resold or otherwise transferred. Stock options are designed to provide an incentive for future performance, rather than pay for past performance. If the company gives its employee 100 shares of common stock and a new automobile as a reward for a successful year, it is fair to say that the stock and automobile represent compensation earned, which should be valued and disclosed to shareholders. In addition, it is easy to value the stock and automobile. Executive stock options, however, do not necessarily represent

compensation earned at grant. The compensation arguably is earned when the option vests or at the time when the executive receives something that can be sold -- namely the underlying common stock on the date of option exercise. This is not to say that the executive has not received something of value on the date of grant, only that a superior measuring point may be elsewhere on the time line.

A Black-Scholes model may significantly overvalue options given by companies that are not able to increase the stock price during the option period and may undervalue options granted by companies that experience significant stock price appreciation. If option valuation at the time of grant creates the opportunity for distortion, then the answer to the options dilemma may be enhanced disclosure. If shareholders are provided sufficient objective information, they should be able to understand the registrant's compensation strategy, the dilutive effects of the options, and the potential value of all stock options granted. To accomplish this goal, the Commission would need to amend the current rules to require enhanced disclosure of a registrant's option plans, including a statement as to the specific compensatory strategy, a detailed historical account of options

granted and outstanding (including the number of shares subject to the options), the exercise prices, and the current value of the outstanding options as of fiscal year end. The possible dilutive effects of outstanding options should be highlighted. In addition, it may be helpful to provide a table for shareholders presenting a limited number of scenarios, such as the value of executive stock options granted during the fiscal year if the stock price rose at a historical rate. This procedure would not include a present value of the options as of grant date, but would provide shareholders with the tools to understand the potential value of options.

VI. Accounting Treatment

Of course, any discussion of stock option valuation would not be complete without recognition of the fact that the accounting profession has been struggling with this issue for years. Their purpose in valuing an executive stock option is different from the Commission's in that their emphasis is upon whether the grant of an executive stock option should result in a charge to earnings, rather than emphasizing disclosure of executive compensation.

Under current accounting treatment, as set forth in Accounting Principles Board Opinion No. 25, only the spread

between a fixed option's exercise price and the current market price of the underlying common stock need be expensed. If an option is granted with an exercise price equal to the stock's current market price, there would be no expense. This treatment has been under review by the Financial Accounting Standards Board ("FASB"), dating back to its May 1984 Invitation to Comment. Today, the FASB has yet to issue final standards. That should emphasize the difficulty involved in finding a workable solution.

On April 22, of this year, the FASB met to discuss its eight year project studying options. It is my understanding that the FASB determined that there should be a charge to earnings representing the fair value of the options either on the date of option grant, or on the date of option vesting. This is a significant change from APB 25 and is a signal that the FASB is nearing a conclusion. The FASB met again last Wednesday, but it is my understanding that the board was split evenly as to the timing of the charge against earnings.

While I do not have a firm view at this time on the proper accounting treatment for executive stock options, I am of the opinion that the Commission and the Congress should defer to

the FASB in this area. Congress has conferred on the Commission statutory responsibility for defining the content of accounting principles for companies filing with the Commission or making public offerings of securities. Since its inception, however, the Commission has looked to the private sector to establish and to improve accounting principles.

I believe quite strongly that this historical relationship between the FASB and the Commission should be maintained. Thus the establishment of accounting standards, including decisions concerning option valuation, properly belong in the first instance with the FASB. My concern is that an attempt by the Congress to legislate, or by the Commission to promulgate, a formula for disclosure purposes may interfere with the FASB's effort to reach an accounting solution, since there is likely to be a clamor for uniformity or consistency. A formula which may work for purposes of proxy disclosure may not work for purposes of creating the most accurate income statement. Congress too should be wary of any attempt to legislate in this area, since the complexities are, in my judgment, best handled by the accounting profession.

VII. Conclusion

In sum, I agree with the view that executive stock options are valuable and that shareholders should be provided with disclosure that would enable them to determine the stock options' potential realizable value. My problem is with the issue of when and how to value executive stock options. Rather than disclose a specific present value on grant date, using a controversial formula, it seems to me that a more workable solution would be to provide better disclosure tools for the shareholders and to let them draw their own conclusions. If some shareholders like the idea of a present value analysis as of grant date, the Commission can require sufficient disclosure so that these shareholders will be able to calculate the present value of all executive stock options granted during the fiscal year using whatever formula that the individual shareholder deems best. By not mandating a specific formula, the Commission would then not interfere with the ongoing accounting industry effort to determine a proper valuation technique. This approach would address the needs of the shareholders by providing additional useful disclosure about executive stock options that is less susceptible to manipulation, while limiting the costs to registrants

by foregoing the need for complex financial calculations in their periodic reports.