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U.S. SECURITIES AND EXCHANGE COMMISSION**

STOCK OPTION ACCOUNTING AND SECURITIES LITIGATION REFORM

**REMARKS BEFORE
THE ASSOCIATION OF PUBLICLY TRADED COMPANIES
PALO ALTO, CALIFORNIA
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* The views expressed herein are those of Commissioner Beese and do not necessarily represent those of the Commission, other Commissioners, or the staff.

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Today, I would like to discuss stock option accounting pronouncements and the explosion in securities litigation. I know confronting the difficulties associated with each of these subjects weighs heavy on your minds. But that's precisely the problem. As corporate executives, your time is better spent growing and developing your businesses, not worrying about technical accounting theory or why you must cut your R&D budget to pay legal fees.

I share your frustration, and I could go on chapter and verse about both these problems and what they mean for public companies and our economy. But instead of preaching to the choir, I would rather give you my perspective on how the debate on these issues is shaping up. Perhaps hearing how the other side views the issues will help you decide what approach is in the best interests of your shareholders and your country.

First, let's talk about the FASB and stock option accounting. For most of us, the stock option accounting debate boils down to one thing: the cost of capital.

And without a doubt, forcing companies to record an expense when they issue stock options will increase the cost of capital. Period. I know it, you know it, and it seems everyone else in the world knows it -- except a select few accountants and economists.

Some who agree with the FASB have even adopted a mantra to support their views. The mantra goes something like this: The stock option accounting changes should have no effect on stock prices, and if they do, it proves shareholders needed this information in the first place.

To those uninitiated with the markets, this argument is simple, sounds logical, and makes perfectly good sense. Unfortunately, our markets have a tendency to move in ways that are anything but simple, logical, or make good sense. If they did, all stocks would be picked by computers these days.

For example, take Boston Chicken's IPO last week. The deal was initially priced in the \$15 to \$17 range, and it went out at \$20, with just over 2 million shares sold. Within two hours, the price more than doubled to \$51, and closed for the day at \$48.50. Using rough math, that means the company and its underwriters left in the neighborhood of about \$57 million on the table.

Considering who the lead underwriters were, I know those guys are not in the habit of doing a deal and leaving \$50 million on the table.

So what happened? Who knows ... markets at times are as much an art as a science. But one thing is for sure. The company's financial statements did not change one iota from the time the offering was priced and the end of the first day's trading. There was no new information about the company, no bombshell announcements, nothing.

And that is precisely the point. The mantra promulgated by supporters of the FASB rests on a huge assumption -- that stock prices, and hence efficient capital allocation decisions, are based only on "knowledge or information."

Of course, that's only partially true. Capital is efficiently allocated within the parameters of our marketplace -- and the rules and psychology of the marketplace have every bit as much to do with the efficient capital allocation as does the abundance and availability of information. Lower the capital gain tax for small cap companies, and their stock prices would surge. Not from any new financial information about individual companies, mind you, but rather from a change in the rules of the marketplace.

The new accounting standards will add no new information to the marketplace. The SEC already requires companies to tell investors just about everything they ever wanted to know about stock options and more. And the

income statement for every public company clearly tells the world what earnings would be on a fully diluted basis.

Not one shareholder is currently being fooled, misled or deceived by the current accounting for stock options. The information is there – companies report it, the market assesses it, and stock prices reflect it.

But put the FASB proposal in place – and stock prices will go down. Not because new and heretofore unavailable "inside" information is suddenly available – but because the rules of the marketplace will have changed.

And even worse, just talking about putting this proposal in place is already raising the cost of venture capital. That's because venture capitalists price deals in part based on exit strategies, including, of course, public offerings. The FASB's proposals, however, provide incentives for companies to stay private longer. Under the FASB's proposal, non-public entities can omit expected volatility when estimating the volume of their options.

Once a company goes public, however, the FASB would require volatility to be factored into the option valuation equation. Since going public increases volatility, particularly for the growth sector of the market, the value of the options dramatically increases, which of course,

dramatically lowers earnings – just what every new public company strives for.

It is likely that with the FASB's proposals, companies will want to stay private longer – they can use options more freely to attract and retain key employees, and they avoid the earnings hit that going public would entail. For the venture capitalists, this means staying in deals and tying up their money longer, which means they will increase the cost of capital for start-ups and growing businesses.

Remember, these price increases for venture capital are not scheduled for 1997, when the FASB has deemed the value of options must be expensed.

Venture capitalists are raising the cost of capital right now, today, because 1997 and beyond is when they will be looking to exit their deals.

From a public policy perspective, how can anyone credibly argue that raising the cost of venture capital is a good idea? Moreover, how are we making more efficient capital allocation decisions when behavioral changes are not the result of new information, but simply because the rules have changed?

Of course, the FASB has heard these arguments before, and either can not or will not accept them. They appear to have already made up their minds. They said as much last month in their summary remarks at the hearing before the Senate Subcommittee on Securities. Quote: "Have we made up our minds that stock options are compensation that should be recognized? Yes."

This quote speaks volumes. Not only has the FASB already decided that stock options represent compensation, but they have also already decided that it ought to be recognized as an expense. To me, the only conclusion is that the FASB is no longer concerned with the issue of should we or shouldn't we, but only how.

So what can be done? Despite the FASB's public comments, I do not believe the war is over, even if the FASB appears to have unilaterally decided that the first battle is not worthy of a fight. In my view, what this debate needs is for more venture capitalists and market experts to weigh in. If I am right, and venture capitalists are raising the cost of venture capital as we speak, and market professionals believe stock prices will fall because of the FASB's actions, but for reasons other than the market receiving new information, the FASB and the public policy makers in Washington need to hear about it.

At the end of the day, it is these arguments that will tilt the balance between the accounting purists and the corporate realists.

Unfortunately, so far the debate has been dominated by those whose comments have been painted as self-serving and self-interested. Despite this depiction, your organization, and others like the AEA, NAM, and the National Venture Capital Association have helped shift the debate from a question of excessive salaries to one of losing the advantages stock options provide. Indeed, one has to wonder if the FASB recently announced a delay in implementing its project because it is beginning to see things in a new light.

But now it's time to take the discussion to a new level. You can do your part by talking to the venture capitalists and investment bankers you know and ask them to add their voices to the steady stream of comments flowing to the FASB, SEC and other policy makers.

Ask them as patriots and concerned Americans to express their professional opinions about how the FASB's proposals will specifically affect stock prices, the prices of IPO's, and the cost of capital. Ask the venture

capitalists to publicly state whether they are currently raising the prices at which they sell venture capital.

You could also ask the analysts that follow your companies to state their views on how helpful they believe these accounting changes will be to them as users of financial statements.

Obviously, the FASB has heard these opinions before. But I believe that if a certain critical mass can be reached, the debate can be moved outside of the ivory-towers of accounting theory, and in the realm of market reality. Then we can all decide what's best for our country, our capital markets and our future.

Shareholder Litigation

Another area where we need to decide what is best for this country is securities litigation. Or maybe I should call it the plaintiff's lawyer's dream lottery: You always have a chance to win big, and even those with losing tickets can usually settle for a prize.

As most of you are intimately aware, shareholder litigation represents a tremendous drag on the productivity and growth potential for corporate America. This is particularly true for the innovative, high-tech industries that our economy is depending on to lead us into the 21st century.

Of course, corporate executives worried about strike suits are not the only people complaining about our system of litigation run amuck. Accountants, doctors, and ironically, even lawyers are being hit every day by law suits seeking more and more money, and product liability suits remain a terrible problem hampering the development of new goods and services.

It seems our country is spending so much time either in lawsuits or trying to avoid them that we have forgotten what our real goals are. At a time when corporate America and its shareholders are demanding the very best independent directors the country has to offer, litigation fears are keeping many of them at home.

Clearly, this is no way to run a railroad, and something must be done.

At the SEC, we realize public companies are facing a difficult problem with strike suits, and we are doing our level best not to add fuel to the fire. In fact, looking at our recent proxy reform and executive compensation

changes, you will see we went the extra mile to make sure we were not exposing officers, directors or their companies to any unnecessary liability. The new Compensation Committee Report and the Performance Chart were accorded the same legal status as the annual report to shareholders, thus insulating them from potential liability in private suits under the proxy rules.

The Commission clearly signaled that we are not looking to private litigants as the primary policemen to monitor the contents of the disclosure provided. Instead, we will look to a much more effective group to supervise compliance: the company's voting shareholders. If the Compensation Committee Report and Performance Charts do not meet their expectations, I want shareholders to turn to the ballot box, not the jury box.

Nothing would be more detrimental to our efforts to encourage more meaningful disclosure than to expose companies to frivolous litigation risks. Certainly, the quantity of disclosure would increase, but its quality would decline as a company's counsel mandated that each statement made by management include all possible defenses to every obscure legal theory a plaintiff's lawyer could possibly imagine. Our regulatory and legal system already imposes on U.S. corporations significant cost disadvantages not faced by their foreign trading partners, and I am greatly concerned that any action we take does not add to that disadvantage.

Moreover, the Commission also owes a duty to those it regulates to make sure the rules and regulations we administer and enact are as clear and unambiguous as possible. Innovative companies and entrepreneurs in today's fast-paced business environment need certainty when considering whether a transaction or deal will take them across a legal line. Uncertainty about the law creates additional risks - and every risk demands its due.

As a nation, we pay the bill for this extra risk on both sides of the ledger. Businessmen must see their lawyers before they can act, certain good deals never get done, and other good deals must be defended through costly litigation after the fact. It is my hope that the Commission will work where it can to clear up ambiguities in our rules, and write new requirements, when needed, through rule-making procedures, not enforcement actions.

Still, these steps only help prospectively, and we all have a problem with securities litigation now. Fortunately, as of late it appears this issue is receiving more and more attention. Congress recently held hearings, and Fortune, the Wall Street Journal and the New York Times have all recently run pieces addressing what can be done. Achieving this level of recognition on the national radar screen is positive sign. In this country, most legislation is reactive rather than prospective.

I thought the Wall Street Journal editorial by John Adler, the CEO of Adaptec, was particularly good. Writing about his own experience with a frivolous law suit, he explained quite thoughtfully the problems strike suits caused for his company, the high-tech industry, and our country, and ended with some very good suggestions. Two I liked were prohibiting plaintiff's lawyers from paying finder's fees or bounties to induce shareholders to sue, and asking that plaintiffs demonstrate that they have more than a \$120 filing fee when initiating costly litigation.

Two weeks later, however, in response to Mr. Adler's article, the Journal also ran a letter that vividly illustrated the difficulties of enacting meaningful litigation reform. Three Adaptec shareholders wrote in to claim that their action was anything but frivolous. Moreover, they claimed that shareholder suits are "the most potent deterrent to financial fraud in this country," and that legislation to curtail class action suits would do nothing more than shield wrongdoers "from their responsibilities to the investing public." In its own way, this letter was equally powerful in presenting the other side of this issue.

Looking how each side has teed up the issues, the more I think about shareholder litigation reform, the more I believe that a modified version of

the English law might be appropriate. I say modified because the loser should not have to pay the winner's costs all the time. Plaintiffs with genuine complaints should be entitled to their day in court without fear of winding up in bankruptcy. The goal must be to stem the tide of frivolous suits, not eliminate shareholder suits altogether.

But corporate defendants also deserve this same consideration. They should not have to pay their own way to bankruptcy by footing the bill for seemingly endless discovery, only to have a plaintiff ultimately decide they have no real case. If plaintiffs are forced to pay all costs for the fishing expeditions they undertake, they may be less inclined to troll for clients within hours after a company announces bad news.

Given that in almost any situation a triable issue is likely to be found, my version of a modified English law might also be improved by allowing judges to make pre-trial determinations of who will ultimately pay each sides costs. At present, corporate defendants face enormous pressure to settle, because the costs of losing are too great. I would like to see if the balance of power between the parties could be re-adjusted slightly so that plaintiffs and their lawyers also have to think long and hard before taking a case to trial.

This may ultimately lessen the likelihood of coercive settlements, but will do nothing to prevent plaintiffs with real injuries from gaining redress at trial. Corporate defendants frequently complain of the unfairness of paying to settle when they did nothing wrong. Perhaps to add some degree of reasonableness to the settlement process, it is time to force plaintiffs to deal with these same types of tough decisions.

This proposal is just a start, and I welcome your suggestions. Much like the stock option accounting issue, reforming our system of securities litigation will involve this country's public policy makers deciding what is in our best economic and national interests.

For American workers, their companies and our country, the importance of stock options and litigation reform can not be underestimated. And I stand ready, willing and able to do what I can to help the fight to make sure the right public policy decisions are ultimately made.