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National Association
of Manufacturers

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March 18, 1992

The Honorable Richard C. Breeden
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Chairman:

It is our understanding the commission is studying the issue of stock option valuation, enhanced disclosure of executive compensation, and accounting treatment of stock option grants. On behalf of the 12,500 members of the National Association of Manufacturers (NAM), I am submitting this comment letter to apprise the commission of our deep concerns in this area.

In summary, we believe estimating the present value of stock options for the purposes of disclosure is a highly problematic and conjectural exercise. Requiring issuers to use present valuation calculations in the disclosure process would be inconsistent with the principle that disclosure should be based on fact. We therefore oppose adoption of such a requirement.

Current accounting treatment of stock options is adequate and is not in need of remedy. In addition to being unable to discern any problems with current practice, we are deeply concerned that requiring the present value of stock options be charged to earnings will unnecessarily wreak great harm on many companies and the economy generally.

Finally, the commission has statutory authority under the securities acts to determine accounting procedures and methods. In exercising that authority, we believe the commission should ensure that the economic consequences of accounting conventions are fully addressed in the accounting standards-setting process.

I. Estimates of the Present Value of Stock Options are Conjectural and Would Not Serve the Purposes of Disclosure.

The commission has hinted that it may explore requiring use of a stock option pricing model to value stock option grants at an estimate of their "present value." Because all such valuation methods are fundamentally conjectural, we believe adoption of a method by the commission would result in the diminution of the quality and reliability of disclosure. We therefore urge the commission not to adopt such a requirement.

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The commission should not stray from the principle that disclosure should be generally free of conjecture. The entire edifice of disclosure policy is based upon the principle that, for the protection of investors, disclosure must be full, fair and accurate. Implicit in the requirement of accuracy is that disclosure based on conjecture should be eschewed, unless accompanied by "key assumptions," which "are of such significance that their disclosure is necessary" to meet reasonable basis and good faith standards.[1]

Regardless of the method used to determine the present value of stock option grants, they all suffer from the same fatal flaw. Namely, central elements in predicting the future price of a company's stock are unknown, and unknowable, variables. Similarly, the specific variables in the present value equation are themselves "best guesses." Indeed, as FASB eloquently stated:

> [p]resent value measurement is always based on estimates of the future. Because the future cannot be known in the present, those estimates will usually turn out to be "wrong" to some extent. Choosing present value does not, as sometimes suggested, imply an ability to make estimates with great precision. Indeed, the opposite is true.[2]

Take the "minimum value" method. Under this method, the "minimum value" of a stock option is the market price of the stock at the time of grant, minus the present value of the exercise price and the present value of dividend payments over the option term. Since it is the predictive value of the method that is at issue, relying on past dividend performance to predict the dividend payments that will occur over the next 10 years is of obvious limitations. While admittedly many companies attempt to maintain a steady dividend stream, relying on that stream to continue for 10 years without material change strikes us as fanciful, particularly in today's economic climate.

Beyond predicting a stock's future dividend stream, all valuation models require determining a realistic "discount rate," which involves making several explicit assumptions (themselves often a matter of debate), which in turn are necessarily made up of numerous implicit assumptions. The discount rate, for example, includes at a minimum "guesstimates" of 1) the "risk-free" rate of return, 2) a measure of the risk of default called a "risk premium," and 3) an element to account for the "term structure" of the measurement period (in the case of stock options, the exercise period (ordinarily 10 years). The usefulness of the discount rate, furthermore, is fully dependent on accurate estimates of these constituent elements. "Reasonably"

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[1]Sec. Act Rel. No. 6084 (June 25, 1979).

[2] Present Value-Based Measurements in Accounting, Financial Accounting Standards Board, 20 (Dec. 7, 1990).

accurate estimates, however, are not themselves sufficient, since "[s]mall changes in estimates of interest rates or the amount and timing of future cash flows [dividends] can produce significant changes in the measurement."[3]

Although we recognize that option valuation has become far more sophisticated in recent years, and presumably marginally more accurate, stripped of its technical cloak, option pricing will never serve to predict future earnings, cash flow, market share, capital spending requirements, the vagaries of economic and market trends, or governmental policy. In short, until a model is developed to predict those factors that determine the future price of a company's stock, calculating the present value of stock options with any degree of certainty will remain an elusive goal.

The objective to be served by the valuation method is a significant consideration in deciding whether to choose present value. There is a meaningful difference between valuation for disclosure and valuation for public trading. The commission should bear in mind that the many valuation models created to date are to facilitate the trade of options on options markets. In a trading setting, once offered, the initial valuation takes on less importance since a vigorous, efficient market thereafter provides a superior pricing mechanism. The predictive "burden" of the pricing method, moreover, is mitigated by the short exercise period that accompanies publicly-traded options -- typically 3-6 months.

Valuation for the purpose of public disclosure (not to mention for accounting purposes) is a wholly different matter. The touchstone of compensation disclosure should be fact. And the pertinent facts relating to option grants are those currently required to be disclosed -- the shares granted, the exercise price, and the net proceeds realized from options exercised.[4] An estimate of the present value of options granted is not a factual matter and should therefore not be required by the commission.

In addition to the difficulties of meaningfully valuing stock options, it is not clear the market would place any value on this type of disclosure. It is our conclusion that notwithstanding a few vocal commentators, there is scant, if any, interest among the investor community for present value disclosure. Not only is investor demand for such disclosure uncertain, there is a strong likelihood that rather than serving to inform investors and the market, it would confuse the issue of executive compensation -- overstating in it one instance and understating it in another. And in any case, using present valuation in the disclosure context would bestow upon it an imprimatur of accuracy and faithfulness it is incapable of rendering.

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[3] Id.

[4] See, Item 402(a), Regulation S-K.

Realistically, present valuation should be viewed merely as a tool among several to value an asset or liability. When viewed in the appropriate context, and its limitations fully understood, present valuation techniques are useful. To import this valuation tool into the realm of disclosure policy, and to present it as a factual representation that may be relied upon by investors, is to greatly diminish the value of disclosure.

If the commission feels compelled to seek public comment on a particular valuation method, we would strongly encourage that the release contain a historical demonstration of the method's accuracy. We recommend that such a demonstration of the predictive value of the commission's method involve selection of a group of stocks representative of the broad market (i.e. cyclical, growth, mid-cap, as well as across industry sectors). By then choosing a sample exercise period (1982-1992, for example) and a hypothetical option grant the commission will be able to test the degree to which the model accurately predicted the future stock price.

A demonstration of this kind will either powerfully answer the critics or demonstrate the futility of attempting to meaningfully express the present value of stock options.

II. Current Accounting Treatment of Stock Options is Adequate and is <u>Not in Need of Remedy.</u>

The commission recently directed its chief accountant, in consultation with the Financial Accounting Standards Board (FASB) and other pertinent accounting bodies, to study the adequacy of current accounting rules for grants of stock options and to report to the commission within 120 days. While we recognize the accounting treatment of stock options has been an issue in the political bodies, we do not believe there is a problem requiring a remedy and therefore urge the commission not to upset current practice.

Not only are we unable to discern any problems with current practice, we are deeply concerned that requiring the present value of stock options be charged to earnings will profoundly harm many companies. The most palpable result would be felt society-wide. Stock options as a pay-for-performance mechanism would greatly diminish in use. For a great number of smaller, growth-oriented enterprises, moreover, a standard requiring a charge to earnings would all but force the abandonment of significant use of stock options.

One of the great success stories of managerial innovation, the widespread use of stock options has brought entrepreneurial instincts to a wide range of companies. Enhanced productivity, innovation and shareholder value have been the direct consequence of the increase in option-based compensation. It would be a tragic mistake to encourage or adopt a policy that would make it economically impracticable to gain the pay-for-performance benefits of stock options.

Erroneously referred to by some as "stealth compensation," stock options are in fact just the opposite. Indeed, they are the only element of compensation explicitly approved by the shareholders.[5] Stock options are thereafter subject to annual proxy disclosure, footnote treatment in financial statements, and the estimated present value of options annually grace the pages of numerous business publications. A virtual cottage industry of proxy advisors and analysts, moreover, has sprung up to inform the world about the compensation practices of publicly-traded companies.

Under new Rule 16,[6] furthermore, stock options acquired, disposed of, or beneficially owned must be reported 10 days after the end of the month during which a change in ownership of such options occurs, as well as on an annual basis. The disclosure must include in tabular form the date and type of transaction, the exercise price, market price and amount of securities involved. To suggest there is anything but the fullest disclosure and public discussion of stock options, therefore, is to deliberately ignore plain truths.

Critics advocate accounting changes in the name of protecting shareholders, yet cynically, it is the shareholders who would bear the brunt of such changes. Shareholders would face an economic catch-22. They would either lose the benefits of stock options as a means of aligning management interests with those of the shareholders, or alternatively, by retaining stock options they would suffer the share price consequences that would result from requiring a charge to earnings. The ultimate loser, of course, would be the U.S. economy.

While we appreciate that no decisions have yet been made, we strongly encourage the commission to reject calls to change current practice in stock option accounting, and work to educate policymakers of the importance of stock options to U.S. economic competitiveness and vitality.

Finally, we are concerned that the debate over stock options has created an improper and unnecessary linkage between balance sheet treatment and proxy reform disclosure. We view them as fully distinct and separate issues both as a conceptual and practical matter. As the commission proceeds to address these issues, we ask, therefore, that any linkage be severed and that disclosure policy not be permitted to affect accounting policy and vice versa.

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[5] See, NYSE Company Manual, Sec. 312.

[6] See, Rule 16, Form 4 and Form 5.

III. Commission Should Generally Ensure Economic Consequences of Accounting Conventions are Fully Addressed in Standards-Setting Process.

The commission is empowered under Section 19(a) of the Securities Act of 1933 and Section 13(b)(1) of the Securities Exchange Act of 1934 to determine financial accounting methods and procedures. The commission has made it clear, however, that it looks to

> the private sector for leadership in establishing and improving accounting principles and standards through the FASB [Financial Accounting Standards Board] with the expectation that the body's conclusions will promote the interests of investors.[7]

We believe this public/private relationship has worked well and the commission has rightly resisted its own inclinations and insistence of others to upset the standards-setting process. It is incumbent upon the commission, however, to concern itself with the economic consequences of accounting conventions, and to take steps to see that the standards-setting process addresses those effects in a proper manner.

We recommend that the study by the SEC chief accountant be designed to help identify the relevant issues and policy questions, particularly with respect to the economy-wide implications of accounting policy. We strongly urge that the importance of pay-for-performance mechanisms and the appropriateness of current accounting treatment of those mechanisms be fully reflected in the report.

We appreciate the opportunity to communicate our concerns, and stand prepared to assist the commission as it addresses these issues.

Sincerely,

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[7] Accounting Series Release No. 150 (1973).