Testimony of

Jeffrey P. Mahoney

General Counsel

Council of Institutional Investors

before the

Permanent Subcommittee on Investigations

of the

Committee on Homeland Security and Governmental Affairs

June 5, 2007

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Prepared Statement

Chairman Levin, Ranking Member Coleman, and Members of the Subcommittee:

Good morning. I am Jeff Mahoney, general counsel, of the Council of Institutional Investors ("Council"). I am pleased to appear before you today on behalf of the Council. I have brief prepared remarks and would respectfully request that the full text of my statement and all supporting materials be entered into the public record.

The Council is a not-for-profit association of more than 135 public, labor and corporate pension funds with assets exceeding $3 trillion. Council members are generally long term shareowners responsible for safeguarding assets used to fund the pension benefits of millions of participants and beneficiaries throughout the United States ("US"). Since the average Council member invests approximately 75 percent of its entire pension portfolio in US stocks and bonds, issues relating to US corporate governance are of great interest to our members.

The Council has long believed that executive compensation is one of the most critical and visible aspects of a company's governance. Analyzing and evaluating pay decisions, including decisions involving the granting of executive stock options, is one of the most direct ways for shareowners to assess the performance of boards of directors.

Moreover, executive compensation decisions have a bottom line effect, not just in terms of dollar amounts, but also by formalizing performance goals for executives. As a result, approximately one-half of the Council's corporate governance "best practices" policies focus on executive compensation issues.

In recent months, the Council has been active on three important corporate governance fronts involving executive stock options. First, in March of this year, the Council's general membership unanimously approved a revision to the Council's corporate governance policies. That revision recommends that companies provide annually for advisory shareowner votes on compensation of senior executives. In approving this policy, Council members generally agreed that an annual advisory vote on executive compensation would benefit investors and company governance because it would provide a mechanism for shareowners to provide ongoing input to company boards on how a company's general compensation policies for executives, including policies relating to stock options, are applied to individual pay packages.

Second, the Council has publicly raised concerns with the Securities and Exchange Commission's ("SEC" or "Commission") December 2006 amendments to the Commission's new proxy statement disclosure rules on executive compensation and related party disclosure. Those amendments lessened the usefulness of the information contained in company proxies by changing the requirements for the reporting of the amount of executive stock option and equity-based awards that appear in the new summary compensation table.

As a result of the change, the summary compensation table, as revised, no longer informs investors of the compensation committee's current actions regarding executive stock options and similar equity-based awards. Moreover, the change sometimes results in the

reporting of a negative compensation amount which I believe most parties, including the SEC, would agree is not particularly useful information when assessing the performance of compensation committees.

We are pleased that the SEC staff has publicly acknowledged our concerns and other investor concerns that have been raised about other disclosure issues relating to the initial implementation of the new rules. The SEC staff has indicated that they are initiating a "review project" that will result in a report this fall that analyzes the first year compliance with the new rules. We look forward to reviewing and commenting on the report.

Finally, we have been monitoring the implementation of the Financial Accounting Standards Board's ("FASB") new standard on the accounting for stock options. That standard, which became effective last year for most companies, is important to investors because it closes a "loophole" in financial reporting.

The loophole had the effect of (1) encouraging companies to issue an excessive amount of so-called "fixed-price" stock options to the exclusion of other forms of stock options and other forms of compensation that are more closely linked to long-term performance, and (2) permitting companies to understate their compensation costs distorting financial reports and as a result diverting investment and capital resources away from their most efficient employment.

The ongoing stock option backdating scandal provides a reminder that the financial accounting and reporting for executive stock options is an area in which there is a high risk of misapplication of reporting requirements. The Council, therefore, has been advocating that audit committees, external auditors, the Public Company Accounting Oversight Board, and the Commission, should all actively support the high quality implementation of the new FASB standard on accounting for stock options.

In that regard, representatives of the Council staff and the CFA Institute Centre for Financial Market Integrity recently met with staff of the SEC's Office of the Chief Accountant to discuss our concerns about the potential use in financial reports of prices Zions Bancorporation ("Zions") has received in its recent offerings of a financial instrument they developed called "Employee Stock Option Appreciation Rights" or "ESOARS." Zions has proposed that the price for its ESOARS qualify as a market-based approach for valuing stock option awards for financial reporting purposes both for itself and for other public companies.

After consulting with leading valuation and accounting experts, the Council staff has concluded that, as presently constructed, Zions ESOARS results in a downward biased valuation for stock option awards. The "lowball' valuation would systematically underreport compensation costs, thereby distorting company financial reports. The Council, therefore, has respectfully requested that the Office of the Chief Accountant prohibit Zions and all other public companies from using Zions ESOARS for financial reporting purposes unless and until the fundamental failings of the product have been remedied.

We look forward to continuing to work cooperatively with the SEC, this Subcommittee, and other interested parties to address these and other corporate governance issues relating to executive stock options. Our goal is to ensure that the issues are resolved in a manner that best serves the needs of investors and the US capital markets.

Thank you, Mr. Chairman for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.

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Council of Institutional Investors
before the
Permanent Subcommittee on Investigations
of the
Committee on Homeland Security and Governmental Affairs
June 5, 2007

Full Text of Statement

Chairman Levin, Ranking Member Coleman, and Members of the Subcommittee:

Good morning. I am Jeffrey P. Mahoney, general counsel, of the Council of Institutional Investors ("Council"). I am pleased to appear before you today on behalf of the Council. My testimony includes a brief overview of the Council followed by a discussion of some of the Council's corporate governance "best practices" policies and recent activities relating to executive stock options.

The Council

The Council is a not-for-profit association of more than 135 public, labor and corporate pension funds with assets exceeding $3 trillion. Council members are responsible for investing and safeguarding assets used to fund the pension benefits of millions of participants and beneficiaries throughout the United States ("US").[1] Since the average Council member invests approximately 75 percent of its entire pension portfolio in US stocks and bonds, issues relating to US corporate governance, including issues relating to executive stock options, are of great interest to our members.

Council Corporate Governance Policies[2]

An important part of the Council's activities involves the development of corporate governance policies. The policies set standards or recommended practices that the Council members believe companies and boards of directors should adopt. They are a living document that is constantly reviewed and updated.

The Council's policies neither bind members nor corporations. They are designed to provide guidelines that the Council has found to be appropriate in most situations.

Council staff uses the policies to determine whether and how the Council can respond to certain issues, including regulations proposed by the US Securities and Exchange Commission ("SEC" or "Commission"), accounting standards proposed by the standards setting bodies, and actions taken by publicly traded companies. Council policies also have been used to decide whether the Council should file an *amicus* brief in a lawsuit or help fund litigation. Council staff may without additional approval, take action on an issue that is within its policies and also within budgetary limits, although oversight of those actions by the Council's board is common.

The nine non-officers on the Council's board of directors serve as the policies committee and suggest subjects for policies, review staff policy drafts and decide which policies should be submitted to the full board.[3] All general members of the Council are invited to submit ideas for policies to Council staff or Council directors.

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[1] See Attachment 1 for a listing of the general members of the Council of Institutional Investors ("Council").
[2] See Attachment 2 for the Council corporate governance policies.
[3] See Attachment 3 for a list of the Council's board of directors.

The full board votes on whether to approve a proposed policy. Once approved by the board, the policy is either subject to a vote by the full membership at the next meeting or by mail ballot if the board believes time is of the essence.

Executive Compensation

Most of the Council's existing corporate governance policies address executive compensation issues.[4] Executive compensation has long been a top priority for the Council and its members.

Concerns in recent years have centered not simply on the amount paid to chief executive officers and other top executives, but also on the board processes for setting pay, the disclosure of pay, and the structure of pay and the pay-for-performance metrics. Poorly structured pay packages, including executive stock option packages, may harm shareowner value by wasting owners' money, diluting ownership and creating inappropriate incentives that may damage a company's long-run performance.

The Council endorses reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the "long-term," consistent with a company's investment horizon and generally considered to be five or more years for mature companies and at least three years for other companies. While the Council believes that executives should be well paid for superior performance, it also believes that executives should not be excessively paid. It is the job of the board of directors and the compensation committee to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as company performance, industry considerations and compensation paid to other employees inside the company.

It is also the job of the compensation committee to ensure that elements of the executive compensation packages are appropriately structured to enhance the company's short- and long-term strategic goals and to retain and motivate executives to achieve those strategic goals. Compensation programs should not be driven by competitive surveys, which have become excessive and subject to abuse. The compensation committee should recognize that it is shareowners, not executives, whose money is at risk.

Since executive compensation must be tailored to meet unique company needs and situations, compensation programs must always be structured on a company-by-company basis. However, the Council believes that certain principles apply to all companies and all executive compensation programs.

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[4] See Attachment 2, pages 7-16.

Advisory Shareowner Votes on Executive Pay

One of those principles is that shareowners should be given a key role in executive compensation decision-making, including with respect to decisions involving executive stock options. On March 20, 2007, the Council's general members unanimously approved the following revision to the Council's corporate governance policies addressing this issue:

> . . . [C]ompanies should provide annually for advisory shareowner votes on the compensation of senior executives.[5]

In approving this policy, Council members generally agreed that an annual advisory shareowner vote on executive compensation would benefit investors and the capital markets for a number of reasons.[6]

Provides a mechanism for ongoing input on compensation

First, while investors have grown more concerned about perceived excesses and abuses of executive pay at US public companies, they have limited ability to signal their disapproval to boards or to shape pay policies. A December 2006 study by *The Corporate Library* found that the median total compensation for some 1,700 chief executive officers ("CEO's") nearly tripled from fiscal 1999 to 2005. Ninety percent of institutional investors think US executives are overpaid, according to a 2005 *Watson Wyatt* survey of 55 institutions managing a total of $800 billion in assets.

While non-binding votes on executive pay practices are required in Australia, Sweden and the United Kingdom ("UK"), shareowners of US companies currently have no way to directly vote on all compensation matters. US stock exchanges mandate shareowner approval of equity-based compensation plans and investors must endorse performance criteria before companies can deduct compensation exceeding $1 million, but compensation committees have substantial leeway in setting yearly performance targets and granting awards. Investors at US companies currently do not have a mechanism to provide ongoing input on how a company's general compensation policies are applied to individual pay packages.

Provides a less blunt instrument than withholding support from directors

Second, shareowners can and do withhold support from compensation committee members standing for re-election, but withhold campaigns can be a blunt instrument for registering dissatisfaction with the committee's administration of pay plans and policies. The tactic can threaten the position of directors "who may very well have argued against the issue which causes shareholder concern, and often puts management

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[5] See Attachment 2, page 7.
[6] See Attachment 4, pages 2-4.

in the position of having to defend individual directors," says Bess Joffe, manager for the Americas at *Hermes Equity Ownership Services*. She added, "[t]hese situations tend to escalate and become quite personal, ultimately distracting from the issue at hand."

Non-binding shareowner votes on executive pay might deter votes against directors since shareowners would have a "more specific and accurate place on the proxy to communicate concerns over pay," says Elizabeth McGeveran, vice president for governance and socially responsible investment at *F&C Asset Management* ("F&C"). Of course, if a compensation committee failed to respond to an advisory vote that showed significant shareowner disapproval of pay practices, "investors might vote against committee members the following year," says Daniel Summerfield, investment adviser to the *Universities Superannuation Scheme*, one of the UK's largest pension funds.

Positive results in the UK

Finally, UK regulations requiring advisory shareowner votes on executive compensation went into effect in 2002, and have resulted in "better disclosure, better and more dialogue between shareholders and companies, and more thought put into remuneration policy by directors," according to David Paterson, research director of UK-based *Research, Recommendations and Electronic Voting*, a proxy advisory service. British drug maker *GlaxoSmithKline* ("GSK") is a case-in-point. In 2003, 51 percent of GSK shareowners protested the CEO's golden parachute package by either voting against or abstaining from voting on the company's remuneration report. Stunned, the GSK board held talks with shareowners and the next year reduced the length of executive contracts and set new performance targets, muting investor criticism. Other UK companies got the message and now routinely seek investor input on compensation policies.

There is no guarantee that all the benefits attained from advisory shareowner votes on executive pay in the UK would be realized in the US. Stock ownership is far more concentrated in the UK, and British institutional investors have a strong tradition of standing up to company management and boards. As a result, UK boards are more inclined to take investor concerns about pay seriously. Even so, advisory shareowner votes—by their very nature—would benefit investors in US companies by providing a clear and direct way to communicate their views on executive compensation. "Voting results could also give directors leverage to resist executives' demands for lavish rewards," adds McGeveran of F&C.

In summary, the Council believes that an annual shareowner advisory vote on executive compensation would efficiently and effectively provide boards with useful information about whether investors view the company's compensation practices to be in shareowners' best interests. Nonbinding shareowner votes on pay would serve as a direct referendum on the decisions of the compensation committee, and would offer a more targeted way to signal shareowner discontent than withholding votes from committee members.

Executive Stock Options

Executive stock options have long been an important element of total executive compensation, particularly for CEO's.[7] The Council believes that executive stock option programs can lead to superior company performance when the stock options are performance-based and structured to achieve appropriate long-term objectives that align executives' interests with those of the shareowners.

Preferred Structure

The Council's corporate governance policies set forth the preferred structure and practices for executive stock option awards and other long-term incentive compensation.[8] The structure and practices include the following features:

Performance-based

Stock option award prices should be indexed to peer groups, performance-vesting and/or premium-priced to reward superior performance based on the attainment of challenging quantitative goals.

Dividend equivalents

To ensure that executives are neutral between dividends and stock price appreciation, dividend equivalents should be granted with stock option awards, but distributed only upon exercise of the option.

Size of awards

Compensation committees should set appropriate limits on the size of stock option awards granted to executives. So-called "mega-awards" or outsized awards should be avoided except in extraordinary circumstances, because they may result in rewards that are disproportionate to performance.

Vesting requirements

Meaningful performance periods and/or cliff vesting requirements—consistent with a company's investment horizon, but no less than three years—should attach to all stock option awards, followed by pro rata vesting over at least two subsequent years for senior executives.

Grant timing

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[7] *See, e.g.*, Eduardo Porter, *More Than Ever, It Pays to Be the Top Executive*, N.Y. Times, May 25, 2007, at 3, http://www.nytimes.com/2007/05/25/business/25execs.html?_r=1&oref=slogin&pagewanted=print ("As for the gap between C.E.O. pay and that of executives working under them, one reason may be that the larger share of stock options in top executives' compensation packages these days makes the gap widen when the market is rising, as it was in the late 1990s and generally these days.").
[8] See Attachment 2, pages 11 & 13.

Except in extraordinary circumstances, such as a permanent change in performance cycles, stock option awards should be granted at the same time each year. Companies should not coordinate stock option grants with the release of material non-public information. The grants should occur whether recently publicized information is positive or negative, and stock option awards should never be backdated.

Hedging

Compensation committees should prohibit executives and directors from hedging (by buying puts and selling calls or employing other risk-minimizing techniques) stock option awards.

Proxy Statement Disclosures

Full and clear proxy statement disclosure of executive stock option awards and all other forms of compensation is of significant interest to the Council and its members because it enables shareowners to evaluate the performance of the compensation committee and board in setting executive pay and the pay-for-performance links. The Council's policies provide three principles relevant to proxy statement disclosures of executive stock options and all other forms of compensation.[9]

Philosophy/Strategy

First, compensation committees should have a well-articulated philosophy and strategy for executive stock option awards, which should be fully and clearly disclosed in the annual proxy statement.

Award Specifics

Compensation committees should disclose the size, distribution, vesting requirements, other performance criteria and grant timing of stock option awards granted to the executive oversight group and how the awards contribute to long-term performance objectives of a company.

Ownership Targets

Finally, compensation committees should disclose whether and how executive stock option awards may be used to satisfy meaningful stock ownership requirements. Disclosure should include whether compensation committees impose post-exercise holding periods or other requirements to ensure that stock option awards are appropriately used to meet ownership targets.

SEC Rules on Executive Compensation and Related Party Disclosure

In light of the Council's three principles and other policies on proxy statement disclosures, we are generally supportive of the Commission's new rules on Executive

[9] See Attachment 2, page 11-12.

Compensation and Related Party Disclosure.[10] We are particularly pleased with the new (1) compensation and analysis section that requires enterprises to discuss, in plain English, the compensation committee's overall pay philosophy, practices and goals, and (2) related guidance regarding disclosure of stock option granting practices, particularly the required disclosure of the timing of option grants, the relationship between option grants and the release of material non-public information, and the determination of option exercise prices. These and many other provisions of the Commission's final rule were directly responsive to the Council's recommendations.[11]

We, however, remain disappointed with the Commission's December 2006 amendments to the final rule[12] that substantially changed how executive stock options and other equity-based awards are recognized in the new summary compensation table.[13] Under the original final rule, a company would have had to report in the new summary compensation table the total fair value of stock option or equity-based grants made in a given year. Under the December amendments, however, the total fair value amount has been replaced in the summary compensation table by the accounting expense—the portion of the fair value of the grant made in a given year that is recognized as a compensation cost in the company's financial reports. The reporting of the total fair value of the award has been relegated to a less significant table.

The basis for our opposition to the December change is consistent with the Commission's stated basis for rejecting such an approach in developing the original final rule:

> Disclosing these awards as they are expensed for financial statement reporting purposes would not mirror the timing of disclosure of non-equity incentive plan compensation. While we have imported a financial statement reporting principle to enable disclosure of compensation costs, executive compensation disclosure *must continue to inform investors of current actions regarding plan awards – a function that would not be fulfilled applying financial reporting recognition timing.*[14]

Moreover, the December change can create confusion and result in information of limited usefulness "where the change in market value of an award classified as a liability award is negative, or where it becomes unlikely that the performance condition of a previously recognized performance-based award will be achieved."[15] In those and

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[10] Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732A, Exchange Act Release No. 54302A, Investment Company Release No. 27444A, 71 Fed. Reg. 53,158 (Sept. 8, 2006).
[11] See Attachment 4, pages 30-52.
[12] Executive Compensation Disclosure, Securities Act Release No. 8765, Exchange Act Release No. 55009, 71 Fed. Reg. 78,338 (Dec. 29, 2006).
[13] See Attachment 4, pages 22-26.
[14] Executive Compensation and Related Person Disclosure, *supra* note 10, at 53,172 (emphasis added).
[15] Securities Client Advisory, David B.H. Martin & David H. Engvall, Covington & Burling LLP, SEC Amends Disclosure Rules for Stock-Based Compensation 5 (Dec. 28, 2006) (available at www.cov.com).

other circumstances, compensation cost for accounting purposes may be required to be reduced or reversed potentially resulting in *negative numbers* in the summary compensation table.

As one example, *The New York Times* recently reported that the summary compensation table contained in the proxy statement for Brookfield Homes, a home builder operating in California and Washington, D.C., reported that Ian G. Cockwell, Brookfield's chief executive, made a negative $2.3 million last year.[16] Mr. Cockwell, however, received $620,000 in cash and bonus in 2006, $170,000 in other compensation (mostly dividends on his stockholdings), $4.2 million in option gains and $2.9 million in realized deferred stock gains.[17] Shane D. Pearson, vice president and secretary at Brookfield Homes explains:

> 'New S.E.C. requirements require us to put in this column the amounts we recognize for financial statements, ... Where I think people might get confused is they are used to seeing the grant date fair values.'[18]

The Council also remains disappointed with the process the Commission used to enact the December amendments. The proposed amendments, described by securities law experts as a "surprise move,"[19]became effective the same date the proposal appeared in the Federal Register for public comment—*thirty-one days before the comment period closed*. The inability to effectively comment was particularly disconcerting when (1) investors publicly supported the requirements in the original rule that were amended; (2) investors did not request the amendments; and (3) the amended rules indicated that the Commission concluded that the amendments would benefit investors.

As the 2007 proxy season continues, Council members are also paying special attention to the new disclosures that companies are required to provide about the performance targets that executives must meet to receive bonus payouts. Under the new rules, companies are allowed to exclude information about these targets if revealing those details would cause competitive harm.

The Council is concerned that companies are using the new rules' exclusion far too liberally. A recent analysis by the compensation consulting firm *Watson Wyatt* appears to confirm those concerns.[20] The analysis found that 46 percent of proxy statements reviewed did not disclose specific financial goals for their annual incentive plans.[21]

The Council is also concerned that the new rules do not require compensation committees to reveal much information about other services that their compensation

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[16] Gretchen Morgenson, *Weird and Weirder Numbers on Pay Reports,* N.Y. Times, March 11, 2007, at 1, http://select.nytimes.com/2007/03/11/business/yourmoney/11gret.html?ref=business.
[17] *Id.*
[18] *Id.* at 2.
[19] Martin & Engvall, *supra* note 15, at 1.
[20] Press Release, Watson Wyatt, Specific Executive Pay Goals Often Omitted From Proxy Statements, Watson Wyatt Analysis Finds (Mar. 28, 2007), http://www.watsonwyatt.com/news/press.asp?ID=17222.
[21] *Id*.

consultants may provide. Consultants hired by the board of directors who also provide services to management face an inherent conflict of interest that may be detrimental to shareowner interests.

In October 2006, a large group of Council members sent letters to the compensation committee chairs of the 25 largest US companies (by market capitalization) in the S&P 500 asking for detailed information about services performed by outside compensation consultants.[22] The letters also urged the committee chairs to adopt formal policies to prevent compensation consultants from working for both management and the board.

More recently, the Council's general members unanimously approved a revision to the Council's corporate governance policies addressing compensation advisers. That policy states, in part:

> The compensation committee should develop and disclose a formal policy on compensation adviser independence. In addition, the committee should annually disclose an assessment of its advisers' independence, along with a description of the nature and dollar amounts of services commissioned from the advisers and their firms by the client company's management.[23]

The Council believes that the disclosure described in our policy will, if adopted, better enable shareowners to assess the independence of the compensation committee's adviser.

The Council applauds the SEC staff for publicly acknowledging and agreeing with many, if not most, of the concerns that the Council and other investors have to-date raised about the initial implementation of the new rules.[24] The SEC staff has indicated that they are initiating a "review project" that will result in a report this fall that analyzes the first year compliance with the new rules.[25] We look forward to reviewing and commenting on the report.

Financial Accounting and Reporting

The Council has been, and continues to be, a strong proponent of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* ("Statement 123R"). Statement 123R, which became effective for most companies in 2006, significantly improves financial reporting by requiring that, consistent with the

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[22] Letter from Denise L. Nappier, Treasurer, State of Connecticut et al. to Compensation Committee Chair (Oct. 23, 2006), http://www.state.ct.us/ott/pressreleases/press2006/pr102306letter.pdf.
[23] See Attachment 2, page 9.
[24] Michael Bologna, *New SEC 'Review Project' Targets Compliance* Rules, 86 Bureau Nat'l Aff. A-11-12 (May 4, 2007).
[25] *Id.* at A-11.

Council's corporate governance policies,[26] all stock option awards be accounted for as compensation costs appropriately reducing reported earnings.

Statement 123R eliminated a "loophole" in financial reporting that was exploited by many companies, particularly technology companies, beginning in the 1990's.[27] That loophole permitted companies to avoid the reporting of compensation costs in their earnings statements if the compensation took the form of a special type of stock option commonly referred to as a "fixed-price" stock option.

A fixed-price stock option had to meet certain criteria to qualify for the loophole including (1) the strike price is fixed and not below the grant-date market price, and (2) the expiration date is fixed. As described by one prominent consultant:

> Through this strange but very tempting little loophole, truckloads of option grants were delivered to executives with no expense to the companies granting them. Because of this same loophole, hundreds of billions of dollars of shareholder value were transferred to executives with virtually no controls or limitations.[28]

The Financial Accounting Standards Board ("FASB") initially attempted but failed to eliminate the loophole in the 1990's. In Congressional testimony, Dennis R. Beresford, who was the Chairman of the FASB from 1987-1997 explained:

> As many of you may recall, the FASB had proposed that companies account for the expense represented by the fair value of stock options granted to officers and employees. The business community and accounting firms strongly opposed this proposal and a number of corporations engaged in a lobbying effort to stymie the FASB's initiative.
>
> Certain members of Congress were sufficiently influenced by the appeals from corporate executives that they were persuaded to introduce legislation to counter the FASB's proposal. The legislation would have prohibited public companies from following any final FASB rule on this matter. More importantly, the legislation would have imposed requirements that the SEC repeat the FASB's process on any new accounting proposals, thus effectively eviscerating the FASB. Faced with the strong possibility that its purpose would have been eliminated by this legislation, the FASB made a strategic decision to require companies to disclose the effect of stock options in a

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[26] See Attachment 2, page 13.

[27] *See, e.g.,* Donald P. Delves, Stock Options & The New Rules of Corporate Accountability 6 (Dan Cafro ed., WorldatWork) (2006).

[28] *Id*. at 8.

footnote to the financial statements but not record the expense in the income statement.[29]

The loophole had many negative effects for investors. For example, the loophole led to the excessive use of fixed-price stock options to the exclusion of other forms of stock options and other forms of compensation that are more closely related to long-term performance.[30] Fixed-price options rewarded executives for stock price increases due entirely to market- or industry wide trends and, therefore, generally proved to be ineffective incentives to encourage and reward meaningful and sustainable corporate performance.[31]

In addition, excessive use of the loophole distorted reported profitability and other key financial metrics. The distortion created an unleveled playing field that inappropriately favored companies that were the greatest users of fixed-price stock options. The result was a diversion of investment and capital resources away from their most efficient employment to the detriment of investors and other capital market participants.[32]

Ironically, over 200 companies that took advantage of the loophole did not always qualify for the loophole because they backdated stock option grants making those options ineligible to be fixed-price stock options under the then-existing accounting requirements. The stock options backdating activities appear to have been motivated by a number of factors, including the desire to provide extra compensation to certain executives without: (1) requiring any performance from the executives in return for the extra compensation; (2) requesting approval or even informing existing or potential shareowners that the extra compensation was being granted; and (3) reporting the extra compensation as a cost or expense, and thereby overstating the company's profitability to market participants.

The Council believes that the stock option backdating scandal provides evidence that the financial accounting and reporting for executive stock options is an area in which there is a high risk of misapplication of reporting requirements. To-date about 100 companies have indicated that they must restate previously reported financial reports and the total amount of restatements, revisions and charges exceeds $12 billion.[33] The Council, therefore, advocates that audit committees, external auditors, the Public

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[29] Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Oversight of the Accounting Profession, Audit Quality and Independence, and Formulation of Accounting Principles Before the S. Comm. on Banking, Housing, and Urban Affairs, 107th Cong. 4 (Feb. 26, 2002) (Prepared Statement of Dennis R. Beresford, Chairman, Financial Accounting Standards Board ("FASB") 1987-97). Of note, Permanent Subcommittee on Investigations Chairman Levin was the most consistent and active Member of Congress supporting the independence of the FASB and the FASB's efforts to improve the accounting for stock options.

[30] *See, e.g.*, The Conference Board, Commission on Public Trust and Private Enterprise. Findings and Recommendations, Part I: Executive Compensation 7 (Sept.17, 2002).

[31] *See, e.g.*, Delves, *supra* note 27, at 8.

[32] *See, e.g.*, Alan Greenspan, Chairman, Fed. Reserve Board, Remarks at the 2002 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Ga. 5-6 (May 3, 2002).

[33] Otis Bilodeau, *SEC Settles With Brocade Over Options Backdating, People Say,* Bloomberg.com, May 31, 2007, at 1, http://www.bloomberg.com/apps/news?pid=20601087&sid=aP0K.RTfzYfI&refer=home.

Company Accounting Oversight Board and the Commission should all actively support the high-quality implementation of Statement 123R's principles-based requirements so that the reporting benefits of the new requirements are fully realized.[34]

In that regard, staff of the Council and the CFA Institute Centre for Financial Market Integrity (an organization representing 90,000 investment professionals in 134 countries) recently met with staff of SEC's Office of the Chief Accountant ("OCA"). The purpose of the meeting was to discuss investor concerns about the potential use in financial reports of prices Zions Bancorporation ("Zions") has received in its recent offerings of a financial instrument they developed and named "Employee Stock Option Appreciation Rights" ("ESOARS"). Zions has proposed that the auction clearing price for its ESOARS qualify as a market-based approach for valuing stock option awards as permitted under Statement 123R. Zions plans to use ESOARS to not only value its own stock option awards, but to market the ESOARS approach to other companies for reporting purposes.

After consulting with leading valuation and accounting experts, and retaining a firm specializing in the valuation of stock options to evaluate Zions ESOARS,[35] the Council has concluded that, as presently constructed, Zions ESOARS result in a downward biased valuation that would underreport to investors the true costs of a company's stock option awards. The Council, therefore, has respectfully requested that the OCA prohibit Zions and all other public companies from using Zions ESOARS to value stock option awards under Statement 123R unless and until the fundamental failings of the product have been remedied.[36]

We look forward to continuing to work cooperatively with the SEC, this Subcommittee, and other interested parties to address corporate governance issues relating to executive stock options. Our goal is to ensure that the issues are resolved in a manner that best serves the needs of investors and the US capital markets.

Thank you, Mr. Chairman for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.

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[34] See Attachment 4, page 21.
[35] See Attachment 4, pages 9-18.
[36] See Attachment 4, page 7.