Hearing of the Senate Finance Committee

on

Corporate Governance and Executive Compensation

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Written testimony of Mark G. Heesen

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I am Mark Heesen, president of the National Venture Capital Association. NVCA represents more than 475 venture capital and private equity firms throughout the United States. The mission of the association is to foster understanding of the importance of venture capital to the vitality of the U.S. and global economies, to stimulate the flow of equity capital to emerging growth companies by representing the public policy interests of the venture capital and private equity communities at all levels of government, to maintain high professional standards, and to provide research data and professional development for its members.

My comments today reflect the views of NVCA and its members. While NVCA is a member of coalitions devoted to the preservation of stock options for all employees, the views expressed here, per the wishes of this Committee, are those of the venture capital community who often act simultaneously as board directors, investors and shareholders.

Venture funding is a major factor in promoting innovation and entrepreneurial businesses. In the current economic environment, venture investing was down in 2001 and will continue to be down by a considerable amount this year. NVCA expects that the level of investing will return to a more sustainable pace, likely at the then-record levels seen in 1998 and 1999. In any case, venture capital will remain an extremely important and vibrant participant of our economy.

At its core, venture capital is about long-term investing, and its long-term impact is significant. According to a study by DRI-WEFA, attached as Appendix A, venture capital invested during the period 1970-2000 created 7.6 million U.S. jobs and more than $1.3 trillion in revenue as of the end of 2000. The $273.3 billion of venture capital created companies that in the year 2000 alone were responsible for 5.9% of the nation's jobs and 13.1% of U.S. Gross Domestic Product.

It is important to note that, while a majority of venture investing remains in areas of concentrated high tech and biotech activity, the industry is expanding into more and more regions of the country. Vibrant venture communities now exist in areas that, a few short years ago, were not readily associated with the New Economy. We are also pleased to report that venture capital investments were made in 48 states and the District of Columbia last year—a record for our industry.

The growth of the industry throughout the 1990s has been nothing short of extraordinary. To put this in perspective, it is worth noting that in 1995—a record year for the venture industry at that time—only $5.5 billion was invested in some 1,300 companies. Since then, the industry has grown from a relatively small, misunderstood segment of the economy to a national and increasingly international phenomenon that can rightfully claim to be the catalyst behind the high-growth companies driving our economy. In 2000, venture capital funds had nearly $210 billion under management. Also in that year, a record $103.5 billion in new investments were made in more than 5,400 companies. Nearly 3000 of these companies received venture financing for the first time.

NVCA has a vital interest in the subject of this hearing because few aspects of venture investing are more important than attracting and motivating the executive talent needed to manage start-up businesses. Corporate governance, executive compensation and the alignment of the interests of all employees with venture capitalist investors and other shareholders are critical issues for a vibrant venture capital industry.

I. EXCESSES OR MISALIGNMENTS IN EXECUTIVE COMPENSATION SHOULD BE ADDRESSED THROUGH ENHANCED DISCLOSURE AND IMPROVEMENTS IN CORPORATE GOVERNANCE.

I speak for all NVCA members in expressing our deep concern at the enormous losses sustained by Enron's employees and investors as a result of the apparent fraud that led to Enron's collapse. As investors and fiduciaries to other investors, venture capitalists support efforts by the Congress, the Administration, the SEC and the Exchanges to minimize the risk of recurrence. As part of the U.S. capital markets, venture capitalists look forward to working with all policymakers to ensure that our equity markets remain strong and continue to earn the confidence of investors.

At the heart of the Enron scandal was Enron's failure to give accurate and complete information to its shareowners and to the securities markets in general. We support greater transparency in financial statements, therefore, and more current disclosure of material information for all public companies. While no rules will ever eradicate fraud, we support new rules that will make it harder for companies to hide serious problems and significant transactions.

We are pleased that the SEC is working with the securities exchanges, and that the NYSE and NASDAQ are currently reevaluating their corporate governance listing requirements. The Commission and the Exchanges are the best agencies for addressing these governance and disclosure issues with nuance appropriate to these complex and multifaceted issues.

We note that new corporate governance safeguards and shareholder approval of stock option plans that include officers and directors are under consideration. We believe that this is the right kind of effort to restore market confidence and confidence in the integrity of corporate boards. As the use of stock options has spread to a far wider group of companies, the potential for dilution of shareholders has raised appropriate concerns. Again, accountability and disclosure are the keys to addressing these concerns. Therefore, we applaud this approach to greater accountability in granting stock options so that those who bear the true cost of stock options, the shareholders, will have an appropriate check on any risk of self-dealing. A copy of NVCA's letter to Chairman Pitt is Attachment B to this testimony.

Many of these efforts were in motion long before the Enron news broke. Following through on one of Arthur Levitt initiatives, the SEC has substantially enhanced the current disclosure requirements for stock options plans to enhance the transparency of the potential cost of stock option plans to shareholders. The new rules require disclosures of the total number of securities that a company has available for issuance under all of its stock options plans as well as the weighted average exercise price of options, warrants, and rights outstanding under these plans. The tabular disclosure of the dilutive effect of all stock options plans will give investors a fuller picture of the real cost of stock options – potential dilution – and will show to what degree a company's overall options program is subject to shareholder approval.

We also recognize that even the appearance of self-dealing by executives must be avoided. We support substantially accelerated reports of insider transactions, and note that new real-time reports have recently been proposed by the SEC. Through better disclosure and, if needed, greater restrictions, public investors should have full and timely information on the purchase and sale of company stock by insiders. We support proposals to prevent executives from selling shares during lock-down periods when employees are barred from selling their shares. Clearly, we should have equality and fairness in terms of how and when employees at all levels in a company are able to diversify their holdings of company stock.

In a similar vein, NVCA supports tough enforcement against those who game and misuse the system. We have encouraged SEC efforts in a number of areas, for example, we support the use of disgorgement of executive bonuses and other incentive-based forms of compensation in appropriate cases.

As we move to create new rules, it is important to take note of the many rules that already require disclosure and restrict transaction by insiders. Appendix C to my testimony covers most of the current rules that are applicable. Certainly, to the extent that the SEC's enforcement powers need to be enhanced to ensure that wrongdoers are punished, we will fully support such legislation. If the SEC needs more resources to accomplish its mission of protecting investors and promoting capital formation, we support additional funds for that purpose.

In addressing purported Enron concerns, however, we must be cautious toward measures that will not prevent future "Enrons" and will, in fact, cause harm. S. 1940 is such a measure. would force companies into Hobson's choice – take an inaccurate "fair value" expense charge for stock options when options are granted, or forgo any tax deduction when the grantee exercises the options. The likely result in most cases is the death of broad-based stock options plans. We think this result would have devastating consequences – for us as investors, for the companies in which we invest, and for the economy. Stock options are a critical factor in fueling entrepreneurial innovation and economic growth, and they embody a principle that Enron does nothing to diminish: employees should have a financial stake in, and financial responsibility for, the companies they help to build.

II. THE CURRENT TAX TREATMENT OF STOCK OPTIONS IS CONSISTENT WITH SOUND TAX POLICY AND COMMON SENSE.

Neither stock options accounting nor the taxation of options income caused Enron to collapse. Stock options never pose a liability the way Enron's "special purpose entities" and guarantees did. Nor are stock options related to the 401(k) issues that arose at Enron. Enron collapsed for a whole web of reasons including poor management, poor accounting standards, a flawed business plan and a governance breakdown. The tax and accounting treatment of stock options are noise in the background to the real solutions to Enron.

"Non-qualified options," or NQOs fall under Section 83 of the Tax Code, which treats the taxation of stock options in a straightforward and understandable way. When an options grantee (typically an employee or a director) exercises in-the-money options, the grantee taxpayer recognizes ordinary income equal to the difference between the exercise price and the market price on the date of exercise. The grantee includes this income in calculating taxes in that tax year. This treatment is consistent with the general rule that whenever an employee receives something from an employer that has "value" to the employee, it is income unless Congress says otherwise. In the same tax year, the corporation is entitled to a deduction in an amount corresponding to the grantee's income. This treatment is not because the employer has an "expense" but because of the general rule that whenever an employee recognizes income, the employer-corporation is entitled to a corresponding deduction.

The impact on U.S. Treasury receipts is, therefore, essentially offset at the exercise date, when the gain to the grantee is fixed. While this policy can work a hardship on employees who fail to segregate sufficient funds to meet their tax liability in that year, it's logic is irrefutable and has not been seriously questioned as a matter of tax policy.

Congress' creation of incentive stock options or ISOs, which qualify for different tax treatment is instructive as to the symmetry of income and deduction. When ISOs were created as non-taxable stock options it was made clear that the corporation was not entitled to a deduction because there was no income to the employee. Therefore, except in certain circumstances, this is the cases for all ISOs. However, if an ISO is not held by the employee for the statutory time period after exercise, the rule of symmetry works the other way, making the difference between exercise price and market price taxable to the employee and deductible to the corporation.

III. THE LEVIN-MCCAIN APPROACH TO STOCK OPTIONS IS BAD TAX POLICY.

S. 1940 would undermine this logic in an attempt to force a change in corporate behavior in financial reporting. This approach would undermine both the logic and symmetry of Section 83, the private sector accounting standards setting process and Congress' role in setting tax policy. By limiting the deduction to the corporation to an amount equal to the book entry expense at grant date – an amount that has nothing to do with the income recognized on the exercise date, S. 1940 would destroy the standard symmetrical relationship between the ordinary amount of income taxable to the grantee and the deduction to which the grantor is entitled. Although S. 1940 calls for a matching of the corporate tax deduction in the year the grantee exercises the option to the expense the company booked in the year in which the options were granted, such matching is impossible. The time separation between the book entry at grant and the tax event would be at least three years in most cases and as many as ten years in many cases because the right to exercise the option vests over a period of years. Thus, because of vesting, the book expense and the tax deduction will never match either in amount or in timing.

Furthermore, the tax deduction of the book expense will never materialize in many cases. Options will lapse because the exercise price never goes above the market price after the option is vested. Other options will also be forfeited before they vest when an employee leaves the company.

Under S. 1940 new mismatches will be created because of the tax treatment of ISOs. As noted above, the tax treatment depends upon whether the options are incentive stock options

("ISOs") or non-qualified options. However, the ISO/non-qualified option distinction that exists for tax purposes has no relevance in the financial accounting world. Instead, the financial accounting treatment of stock options depends upon whether the stock option plan is "fixed" or "variable." And if an expense is to be recognized, it must be recognized for all fixed and variable option plans. Thus, a book expense would have to be recognized for all options even if the company never could, under the tax rules, recognize a tax deduction (such as with ISOs).

S. 1940 is misguided for a number of additional reasons. For one, it would take the question of when and how much tax deduction is appropriate out of the hands of Congress and the Treasury and place it in the hands of the Financial Accounting Standards Board (FASB) and the SEC. S. 1940 attempts to address the disparity between book and tax accounting, not by changing the tax accounting rules *per se*, but instead, by requiring companies to recognize an expense for book if they want to recognize an expense for tax. Because the tax treatment of options would be driven solely by the financial accounting treatment, the deduction that the corporation would be entitled to would be based upon the rules of the FASB and the SEC, which recognizes the FASB's rules as appropriate for SEC-filed financial statements. At some point, this same determination could be in the hands of the International Accounting Standards Board, which works with accounting standards constituencies from around the world.

S. 1940 would also reduce the R&D tax credit for companies that do not recognize a fair value expense for stock options. In addition, for those companies that do expense stock options, their credit would likely be reduced and the already complex R&D tax credit computation will become even more complicated. The mismatches and administrative problems created by Levin-McCain will simply make matters worse by diminishing the tax credit's impact on the policy goal of encouraging R&D in the U.S.

Furthermore, Levin-McCain would promote arbitrary and potentially unsound financial reporting results that would then be reflected in tax deductions. Even assuming that there should be an expense, the option pricing models required to be used to value fixed options are not adequate to create a meaningful estimate. For example, the Black-Scholes option-pricing model, was designed to value freely tradable options such as those traded on the New York and American Exchanges– not employee stock options. Indeed, these are the types of options that Black-Scholes was designed to value. However, as Burton Malkiel and William Baumol, two well-recognized academics, recently stated in the *Wall Street Journal*, the Black-Scholes model was never intended to value employee stock options and cannot do so reliably. Too many assumptions must be made as to the marketability and transferability of options; vesting and exercise periods; projected dividends; and the volatility of the underlying stock over the entire life of the options. In addition, Black-Scholes was designed for options that are only exercisable at expiration. Most employee options vest and are then exercisable for a period of time. Option pricing models do not accurately account for these factors. Each of these assumptions leaves considerable room for honest mistakes – and for manipulation.

Many stocks pay dividends. Option pricing models generally make the opposite assumption. Thus, if a company does pay dividends, another assumption must be made to reduce the current share price used in the computation to reflect expected or projected dividends. As today's market shows, these projections can produce results far from reality. Another significant prediction that must be incorporated into such models is the volatility of the underlying stock expected over the life of the option. Could anyone have predicted that Enron's stock would triple in two years and then fall to be virtual worthlessness in a year? The wild fluctuations in

Enron's stock, although more extreme than most for obvious reasons, was not limited to that company. Stock market volatility simply cannot be predicted with any degree of certainty.

Some suggest that the inadequacies of Black-Scholes make expensing at the exercise date rather than the grant date appropriate. However, requiring expensing at the exercise date would produce even more misleading and unreliable financial statements. Since the "cost" would equal the difference between the stock price and the option exercise price, the better the company was at increasing shareholder value, the more its earnings would be reduced. The best performing companies would have the worst looking income statements. Attachment D demonstrates this situation. Such results do investors no good.

As written, S. 1940 would make the tax decuction dependent on the Black-Scholes formula. It will also make a company's tax deduction differ vastly from the amount of income the employee is required to report. As a tax policy matter, there is no reason to make a company's tax deduction totally dependent upon such an inherently imprecise and arbitrary number. This is simply bad tax policy and adds unnecessary complexity to the Code.

Aside from tax policy, it is possible that S. 1940 would cause an increase in the number of financial statement restatements if a companies actual expense turned out to be materially different from the one reported under Black-Scholes.

The Levin-McCain approach will create an administrative nightmare by requiring an option-by-option, employee-by-employee tracing of the financial accounting expense in order to determine what tax expense the company could deduct. This administrative nightmare is a direct threat to the continued use of broad-based stock option plans.

IV. S. 1940 IS BAD ECONOMIC POLICY.

Stock options are a vital tool in the battle for economic growth and job creation. Stock options relate directly to the ability of companies, large and small, to attract, retain and motivate talent. Stock options are now utilized across the board by retail companies, manufacturers, biotechnology companies and, of course, high-tech companies. And they are increasingly granted to middle management and rank-and-file employees: The National Center for Employer Ownership estimates that up to 10 million employees in the United States will receive stock options in 2001, up from one million who received them in 1992. It also notes that, as of 2000, "90 percent of large publicly traded companies have stock options programs . . . and that 100 percent of venture backed companies offered stock options." This level of employee empowerment and commitment are at the heart of America's productivity gains over the past decade.

With entrepreneurial thinking, due in part to the current treatment of stock options, U.S.-based companies have a competitive advantage over their foreign counterparts. Levin-McCain-Fitzgerald would take this away. The current economy, especially the high tech economy, needs workers with the commitment and motivation that options provide.

V. STATEMENT OF FINANCIAL ACCOUNTING STANDARD (SFAS) 123, DEVELOPED THROUGH THE FASB PRIVATE SECTOR ACCOUNTING STANDARDS PROCESS IS THE RIGHT STANDARD FOR ACCOUNTING FOR STOCK OPTIONS.

Since 1995, THE FASB rule, SFAS 123 has permitted two methods of accounting for fixed stock options. Both methods call for accounting at the date of the options grant. However, companies can report an expense under one of two approved methods. The older of the two methods is based on "intrinsic value" which is the difference between the market price and the exercise, or "strike" price. In most cases, options are granted with a strike price at the market price, making the intrinsic value of the option at grant zero and creating an expense of zero. This method reflects what NVCA believes is the real cost to the corporation at grant – zero.

While permitting the use of intrinsic value, SFAS 123 encourages companies to report the expense under the “fair value” method of accounting. This requires the company to use a model-based approach to assigning a value, the most common of which is the Black-Scholes model. If companies do not record an expense at fair value, they are required to provide extensive footnotes that show what the impact of such an expense would have been on earnings per share. Therefore, regardless of whether a fair value expense is recorded, and regardless of whether the company or its investors see the grant of options as a cost to the company, anyone who wants to consider this information in analyzing the financial report of the company has it fully available on an annual basis.

Current accounting rules mandate that companies report their earnings per share as if all in-the-money options were exercised. This treatment reflects the reality of stock options: when, and if, they are exercised, a portion of the corporate ownership and claim on earnings shifts from current shareholders to the employees. There is no corporate level expense as there is when cash salaries are paid.

Significant additional information on stock options is reported elsewhere in financial statements and SEC disclosure. See, Appendix C.

Intrinsic value accounting, footnote disclosure of ‘fair value” and diluted earnings per share combine to give investors the best available accounting for stock options. Options are not a cash expense, and they require no dissipation of the corporation’s tangible assets.

Finally, as noted the "cost" of stock options is already reflected in corporate earnings per share. The dilution that shareholders absorb is part of the entrepreneurial bargain that boards and shareholders make when options are granted to employees.

VI. THE IMPACT OF A CHANGE IN EITHER ACCOUNTING OR TAX TREATMENT THAT WOULD MAKE STOCK OPTIONS MORE "EXPENSIVE" WILL HAVE AN ADVERSE IMPACT ON THE ENTREPRENEURIAL ECONOMY.

It is important to remember that the proposal to expense stock options is not a new idea resulting from the Enron crisis. Differing views on stock option accounting were argued extensively from 1986 to 1995. Several studies and surveys conducted at the time found that requirements to expense stock options would lower corporate earnings unless there were significant cutbacks in broad-based employee stock option programs. They also concluded that middle-class Americans would be hit the hardest, by depriving them of the options-based gains they use to buy homes, put their kids through college and provide for retirement. And it was clear that small-to-medium sized-companies, especially startups, would be hurt because of their reliance on options as a way to lure employees away from higher paying, more stable jobs. At the end of this useful debate, a compromise was reached that worked for everyone – it did not require companies to expense stock options, therefore saving broad-based stock options plans. It required, however, that companies choosing not to expense options disclose the effect of a "fair value" expense charge on net income and earnings per share in the financial statement footnotes, thus giving investors transparency. And the accounting rules have been tightened and other disclosure requirements have been added since then.

This was the right approach for the US Economy. During the last decade, stock options were a critical factor in fueling entrepreneurial innovation and economic growth. Central to the tremendous growth and global leadership of the American economy have been men and women motivated by the dream of financial independence through employee ownership. By offering employees the opportunity to share in the rewards as well as the risks of innovative new start-ups, entrepreneurs can attract the top talent and the venture capital necessary to turn a great idea into a thriving enterprise. Broad-based option plans allow every employee, from the CEO to the rank and file worker, to have a stake in the company's success.

Venture capital investors are among the firmest believers in the use of stock options for two purposes. First, it takes stock options to lure the kind of managerial talent that is highly prized in any business to the risky, intense and volatile experience of the start-up. Second in takes stock options to bring the focused, highly-motivated sense of shared purpose that is critical to the success of an innovative new venture. Venture capitalists are investors who affirmatively give up part of their stake in the company because they believe that there is no better way to recruit talent, motivate employees and grow a company.

Without a doubt, stock options are an important part of successful formula. Venture-backed companies, steeped in the culture of shared ownership, have had an enormous impact on the American economy. As noted earlier an NVCA-commissioned independent study by DRI-WEFA, which measured this impact, is attached. DRI-WEFA major findings bear repeating: from 1970 to 2000, venture-backed companies have created more than 7 million new jobs, 5.9% of the U.S. total. These same companies generated $1.3 trillion in revenue, 13.1% of GDP, in 2000 alone. In the current shower of negative press over the excesses of a few, it is important to keep our eye on the real economic prize and the role that stock options have played in maintaining economic growth.

As we can see from the troubles in many economies, here and abroad, growth in jobs and GDP cannot be taken for granted. The U.S. faces significant challenges in continuing to develop the means to give every person the tangible rewards and the sense of purpose that comes from participating fully in economic life. Stock options are a proven tool at our disposal for meeting these challenges. Just as stock options have been an essential part of the engine that has driven America's entrepreneurial leadership and economic growth over the last decade, they can be a key to a brighter future for many more. They are in part what distinguishes our powerful economy, and are even more vital growth tools when we need to pull ourselves out of economic downturn.

But the U.S. does not have a monopoly on stock options. We see an example of the need to be prudent in the technology area, which has serious competitors outside the U.S. Taiwan, for example, has built great technology companies on the foundation of stock options. Taiwan companies do not have to expense stock options in their P&L statements. These strong Taiwanese companies have been built with American engineers and managers who joined them in part because of more favorable stock option treatment in Taiwan. The Peoples Republic of China is also beginning to build a technology industry with the help of stock options. Several European nations are revising their accounting rules to encourage the use of stock options. The world has taken notice of our economic success and has discovered the importance of stock options as a competitive tool.

Other jurisdictions are moving to change their accounting and tax rules to accommodate broader use of stock options. We stand to lose our technological edge if we do not continue to offer this incentive to our most ambitious and energetic employees.

I reiterate that what is good about stock options can be preserved and made better through better disclosure, better corporate governance and greater accountability to shareholders. NVCA, and the many business organizations that share our views, look forward to working with the Committee, the SEC and the other agencies that have assumed their proper responsibility in addressing these issues.

Thank you for the opportunity to express NVCA's views on these vital issues.

Attachment A – DRI-WEFA Study

Attachment B – NVCA April 15, 2002 letter to SEC Chairman Harvey Pitt

Attachment C – Summary of Current Disclosure on Stock Options, Restrictions on Insider Transactions and

Attachment D – Examples of Expensing at Date of Exercise