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The following was originally published as a LTE in American Banker, 2003, but may inform FRS consideration of 956. Dear Editor: The compensation of Freddie Mac's former executives, Mssrs. Brendsel, Glenn and Clarke, has come under fire from Congress and the other usual suspects. But the key issue is not how much the executives are paid, but the formula by which they are paid. Compensation amount determines the talent level of the candidates a corporation can attract for officer positions; compensation formulas determine the incentives that will govern how those managers make decisions. Stock options create all the wrong incentives for managers of highly leveraged corporations. Stock options, unlike other equity-linked compensation, are an asymmetrical benefit. The beneficiary shares the upside of equity price increases, but suffers no out-of-pocket losses as equity prices decrease. This one-sided game was expressly designed to make senior managers take legitimate risks. As recently as 1987, only about 1% of all publicly traded companies had broad-based stock option plans. But executives were criticized for being too risk averse on decisions on new capital expenditures and new projects. A CEO with a very high concentration of his personal economic fortune tied up in the expected future salary payments and perks that come from keeping his job is likely to be much more risk averse than the company's shareholders, who have learned through portfolio theory to diversify their holdings. In order to change the risk-averse behavior, analysts advised corporations to provide bigger potential payoffs for managers who made risky decisions. High-risk tech stocks were the natural birthplace for overly generous stock option grants. If you are a high tech company with a product that might be the "Next Big Thing" or might be completely obsolete in 2 years, how else are you going to attract some CEO from a lucrative and safe position selling colored sugar water to the thirsty masses? With the potential for fabulous wealth through the one-way bet of stock

options, that's how. By 2000, an estimated 15% of publicly traded companies had broad-based stock option plans. However, the financial stakeholders of a regular corporation are not limited to stockholders. There are bondholders and others with economic claims on the assets of a corporation. Shareholders are protected, at least in theory, by the fiduciary duty that a CEO owes to his stockholders. Bondholders are only protected by their written contracts. Bondholders, unlike equity holders, are not big fans of stock option compensation plans. Bondholders simply don't like additional risk (because they don't get additional rewards), and stock options always create an incentive for the CEO to take more risk. With Freddie Mac, and all the other Government Sponsored Enterprises, the government has a large contingent potential financial risk. Its position should be at least as risk averse as a bondholder in a regular corporation. Unlike those bondholders, the government is in a position to change its course of action to protect its stake. The one-way payoff of large stock option grants is inappropriate for these highly leveraged companies. While a large amount of fixed annual compensation for the CEO at Freddie Mac will attract a qualified leader and is to the ultimate benefit of the taxpayers, no one wants to face the question of precisely what an "implicit government guarantee" means. Perhaps incentive compensation for Freddie Mac managers should also be tied in part to the spread between the interest rate on their debt issuances and comparable Treasury rates. At the very least, the government can and should require that the perverse one-way incentive created by stock options be abolished at all GSEs. Bart Dzivi, partner Dzivi Law Firm Former acting general counsel FHLB San Francisco