Testimony Concerning Tax and Accounting Issues
Related to Employee Stock Option Compensation

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Chairman Levin, Senator Coleman, and members of the Subcommittee:

Introduction

Thank you for inviting me to testify before you on behalf of the Securities and Exchange Commission on issues concerning stock option compensation. I am pleased to testify with Acting IRS Commissioner Kevin Brown today and to share with you the Securities and Exchange Commission's perspective and insights on this form of compensation, which has become a significant component of executive pay among today's public companies.

Growth of Stock Option Compensation – Current Trends

The growth of equity-based compensation – particularly in the form of employee stock option awards – has paralleled the growth in executive pay over the last three decades.[1] Indeed, some have argued that option awards have been a major driver of this growth.[2] Several factors may have contributed to the now-widespread use of stock options as compensation.[3] Throughout the 1970s, as stock options fell out of favor following a prolonged depression in the stock market, executive compensation packages consisted almost entirely of base salaries and cash bonuses.[4] The popularity of options increased in the 1990's as the steep rise in market prices made options more lucrative to employees. Then, in 1993, the Omnibus Reconciliation Tax Act added Section 162(m) to the federal tax laws. Section 162(m) limited the deductibility of compensation in excess of $1 million paid to certain top executives, but exempted certain performance-based compensation such as stock options. As Chairman Cox noted in testimony last fall: "the stated purpose [of Section 162(m)] was to control the rate of growth in CEO pay. With complete hindsight, we can now all agree that this purpose was not achieved."[5] This change in the tax law tilted compensation practices away from salary and other forms of cash compensation in favor of stock options and other types of non-cash compensation to which the cap did not apply.[6] In addition, companies turned more and more to options as a form of compensation because they believed they helped align the incentives of shareholders and managers. And, for emerging growth companies, the use of stock options as compensation offered a way to conserve resources while attracting top-flight talent in highly competitive markets.[7]

According to academic literature, between 1992 and 2002, the inflation-adjusted value of employee options granted by firms in the S&P 500 increased from an average of $22 million per company to $141 million per company, rising as high as $238 million per company in 2000.[8] One academic study we referenced showed that, whereas in 1992 share options accounted for only 24 percent of the average pay package for these CEOs, by 2002 options comprised approximately half of the typical CEO's total compensation.[9] The practice of granting option awards has not been limited to the top echelon of company executives. The percentage of option grants to all employees has grown steadily as well,[10] if not at the same pace as the very top-most strata of corporate executives.[11]

It is important to clarify, however, that the Commission is, and should be, a neutral observer in matters of executive pay. As a disclosure agency, we constantly seek to improve the total mix of information available to investors and others in the marketplace. Therefore, we focus on ensuring that the description of a company's compensation decisions and practices in its disclosure documents is sufficiently transparent so that investors can properly assess the information and reach their own conclusions to questions such as whether the compensation committee is making sound and informed judgments about executive pay, how assets of the company are being used for compensation, and what incentives and rewards are being provided to management. It is not the role of the Commission to judge what constitutes the "right" level of compensation or to place limits on what management and other employees are paid. One of our central tenets is that it is up to boards of directors, as they are influenced by market forces, to determine how to fairly compensate company personnel, and that shareholders need full and transparent disclosure about executive pay in order to make informed decisions about who to elect as directors.

Stock Option Abuses and Improper Practices

As the use of options compensation has increased, however, we have seen some abuses as well. We have learned that some companies and their executives abused stock option programs by improperly backdating grant dates. That is, they misrepresented the date of an option award to make it appear that the option was granted at an earlier date – and at a lower price – than when the award was actually made. The intent of backdating option grants is to allow the option recipient potentially to realize larger eventual gains, but still characterize the options as having been granted "at-the-money" – disguising the fact that he or she received the options with an exercise price below that of the current market price of the company's stock.

We also learned that employees, including executives, may at times have backdated option exercises. This practice involves misrepresenting the date an option is exercised to make it appear that the exercise occurred at an earlier date – when market prices were lower – than when the exercise actually occurred. The consequence in this instance is to understate to investors the benefit of the exercise for the exercising executive and to reduce the ultimate tax liability of the employee. This reduction in the

employee's tax liability is often obtained to the detriment of the company through a lower tax deduction.

In its efforts to ensure full and fair disclosure and an even playing field for all investors, the Commission has been very active in uncovering and seeking to redress these practices. To date, the Commission has charged two issuers and fourteen individuals (affiliated with eight issuers) with improper stock option grant practices. Of the individuals charged, seven have settled, and seven are litigating. Of the seven settled defendants, five have paid disgorgement and prejudgment interest, and four have paid civil penalties. Additionally, of the seven settled defendants, six have agreed to permanent bars on serving as an officer or director of a public company, and four have agreed to permanent suspensions from practice before the Commission.

The cases brought to date demonstrate some of the types of fraudulent practices we have seen in this area. They involve both backdated option grants and backdated exercises that reduce recipients' taxes at the expense of shareholders. Some involve fraudulent options granted to top executives, and some involve fraudulent grants to rank and file employees. Unfortunately, these cases are not the only matters before the Commission in this area. The Division of Enforcement is currently investigating more than 140 companies concerning possible fraudulent reporting of stock option grants and exercises. The companies under investigation are located around the country. They involve Fortune 500 companies and smaller cap issuers and span multiple industry sectors. It is uncertain at present how many of these cases will ultimately result in enforcement actions.

Additionally, the Commission's Enforcement staff is sharing information related to its investigations with other law enforcement and regulatory authorities as warranted and appropriate, including the Department of Justice and the President's Corporate Fraud Task Force, U.S. Attorney's offices around the country, and the Federal Bureau of Investigation. We are also sharing information with the Internal Revenue Service to ensure that the potential implications for laws within their jurisdiction are fully considered in the course of these investigations.

Despite the Commission's substantial involvement in pursuing this misconduct, it should be pointed out that it would appear that the problem has greatly diminished in recent years. The opportunity for these kinds of abusive practices has been considerably lessened as a result of the Sarbanes-Oxley Act. Before Sarbanes-Oxley, officers and directors were not required to disclose their receipt of stock option grants until after the end of the fiscal year in which the transaction took place. Sarbanes-Oxley changed that by requiring real-time disclosure of option grants. And in August 2002, shortly after Sarbanes-Oxley went into effect, the Commission issued rules requiring that officers and directors disclose any option grants within two business days.[12] Not only must option grants now be reported within two business days, but under rules adopted by the Commission this information is required to be filed electronically. This allows the public almost instant access to information about stock option grants and exercises and makes backdating more difficult.

In 2003, the Commission took another important step that has helped increase the transparency of public company option plans. The Commission approved changes to the listing standards of the New York Stock Exchange, the Nasdaq Stock Market, and the American Stock Exchange to require shareholder approval of almost all equity compensation plans. Companies listed on these exchanges are now required to publicly disclose the material terms of their stock option plans in order to obtain shareholder approval.

Further, in December 2004, the FASB issued Statement of Financial Accounting Standard 123R, which effectively eliminated the accounting advantage that had previously been given to stock options issued "at-the-money". Since this new accounting rule took effect for 2006 for most companies, all stock options granted to employees have to be recorded as an expense in the financial statements, whether or not the exercise price is at fair market value. I will talk more about this significant accounting change in moment.

Most recently, last year the Commission on its own initiative adopted new rules requiring public companies to more thoroughly disclose their awards of options to certain executives. As a result, public companies are now required to report this information in clear, easy to understand tabular presentations in their proxy statements.

Adoption of Revised Executive Compensation Disclosure Rules

The rise in stock option compensation is just one facet of a much larger trend that has seen the types of awards and compensation packages awarded to directors and top executives continue to evolve. Before last year, the Commission had not undertaken significant revisions of its rules for executive and director compensation disclosure in more than thirteen years. Over that time, as the rules themselves remained relatively static, the types of awards and compensation packages awarded to directors and top executives grew ever more complex. Simply put, the disclosure required of companies in their public reports failed to keep pace with changes in the marketplace. The end result was that companies too often did a poor job of giving their investors a clear picture of executive compensation, even though the disclosure may have technically complied with our rules.

Chairman Cox and the other commissioners have made improving disclosure of executive compensation a top priority. The Commission last year adopted comprehensive revisions to the rules governing the disclosure of executive and director compensation. As part of this modernization of the rules, the Commission revamped the disclosure requirements for stock option compensation, including strong new protections against undisclosed backdating or disclosure of so-called "timing" of option grants and of backdating practices.

In particular, the rules require:

- Disclosure in the Summary Compensation Table of the annual dollar amount of compensation cost of option awards recognized by the company for financial reporting purposes in accordance with Statement of Financial Accounting Standards No. 123R;

- Disclosure in the Grants of Plan-Based Awards Table of the full grant date fair value of an option at the time the award is made;

- The exercise price of the option and a comparison of the exercise price to the grant date market price, whenever the exercise price is lower than the market price;

- Disclosure of the grant date of an option and the date when the compensation committee took action on the grant if that date differs from the grant date; and

- A plain English description in the new Compensation Discussion and Analysis section of how the company determined the timing of option awards to executives and whether the company has in effect any program, plan or practice to set an option's exercise price based on the stock's price on a date other than the actual grant date or to time option grants to executives in coordination with the release of material non-public information.

Other Rules Governing Option Plans

In addition to the Commission's rules and regulations regarding stock option disclosures, there is a vast array of state corporation law that is relevant to this subject. As much of that body of law is outside the province of the Commission's regulatory jurisdiction, I will not speak to it in this testimony, except to give only the broadest of outlines.

The general corporation laws of most states include provisions governing the adoption and implementation of stock option plans by a corporation. A stock option plan will necessarily require action by the company's board of directors, or committee thereof, which must authorize the issuance of stock. Stock option plans and grants under those plans will also be dictated by, and subject to, the various limitations and conditions contained in a company's governing documents, including its charter and bylaws. In addition, several states require stockholder approval to grant options to directors, officers, or employees of the corporation or to establish a stock option plan.

Stockholder approval also may be required in certain circumstances under federal tax law and under the policies of the stock exchanges and the federal securities laws.

As for the federal securities laws, publicly owned corporations subject to our proxy rules must comply with the extensive requirements of those rules as to the form and substance of their submissions to shareholders. This of course includes the newly revised set of executive compensation disclosure rules that companies must follow when

they are preparing their annual proxy statements. In addition, if a company intends to take action at a shareholders' meeting with respect to any plan under which cash or non-cash compensation may be paid or distributed, our proxy rules require it to furnish detailed information about the plan and its participants to shareholders.[13] With respect to any plan in which options may be granted, this information includes the eligible participants under the plan and the plan's material features, such as the type, amount, and market value of the securities underlying the options, the prices and expiration dates and other material conditions on which the options may be exercised, and the federal income tax consequences of the issuance and exercise of the options to the recipient as well as to the company.

Current Accounting and Tax Requirements

Under a typical stock option plan, a company grants an employee the right to purchase a specified number of shares of the company's stock at a specified price, known as the exercise price. The exercise price is usually set as the market price of the stock on the grant date, or "at-the-money." If an option has an exercise price less than the market price, it is considered "in-the-money"; in contrast, if an option has an exercise price greater than the market price, it is considered "out-of-the-money" or "underwater." Typically, an employee cannot exercise the option and acquire the underlying stock until serving as an employee for a specified period, known as the vesting period. Once vested, options generally are exercisable until they expire. If an employee leaves the company, he or she generally loses any unvested options and generally has only a limited period (such as 90 days) to exercise options that have vested already.

Before I discuss the specific differences between the accounting treatment and the tax treatment for a typical stock option, it is important that we recognize that historically our financial and tax reporting systems, because they serve very different purposes, have not been designed to necessarily produce exact alignment of results. While financial reporting seeks to reflect the underlying economic substance of an activity, tax reporting seeks to ensure the full and faithful implementation of the tax laws as enacted by Congress. It is not, therefore, surprising to find differences in the accounting treatment of stock options, since these in large part derive from the different purposes that financial and tax reporting serve. With respect to stock options specifically, the major difference relates to the timing at which compensation is measured. For financial accounting purposes, the compensation is typically measured at the date an option is granted and recognized over a period of time; whereas for tax purposes, the compensation is typically measured at the date an option is exercised.

In 1972, the Accounting Principles Board, the predecessor to the Financial Accounting Standards Board (the "FASB"), issued an accounting standard ("Opinion 25"), which required for the typical option grant the recognition of compensation expense for employee stock options only if the option was in-the-money at the grant date (that is, the exercise price of the option was below the market price of the company's stock at the date of grant). The amount, if any, by which the market price of the stock is greater than the exercise price of the option is referred to as the "intrinsic value" of the option. Additionally, as long as the terms of the stock option were set at the grant date and not

subject to change, the amount of compensation expense, if any, was "fixed" at the grant date and recognized over the vesting period.[14] Excluding issues related to backdating, most companies issued at-the-money options, in which no compensation expense would be recognized under Opinion 25 since the options would have an intrinsic value of zero at the grant date. These provisions of Opinion 25 created advantageous accounting for fixed stock options granted at-the-money since no expense would ever be recorded in the financial statements for those options.

In 1995, the FASB issued Statement of Financial Accounting Standards No. 123 (known as "FAS 123"), which permitted companies to elect to either record the fair value of stock-based compensation as an expense or continue to apply the guidance in Opinion 25 if certain disclosures about the fair value of those options were made in the footnotes to a company's financial statements (including the pro forma effects on earnings). Most companies elected to continue applying Opinion 25. In issuing FAS 123, the FASB acknowledged that its decision to allow companies to continue to apply the guidance in Opinion 25 was based on practical rather than conceptual considerations.

In 2002, the international accounting standard setter (the International Accounting Standards Board or IASB) issued a proposal requiring that stock-based compensation be recorded at fair value; this standard was finalized at the beginning of 2004. By this time, some large U.S. public companies were also beginning to elect the fair value based accounting method in FAS 123. In 2004, the FASB issued FAS 123R, which precludes the application of Opinion 25 and instead generally requires the recognition of compensation expense for employee stock options based on the fair value of those options at the date of grant. The fair value amount, typically measured using a market instrument or an option pricing model (such as Black-Scholes-Merton or a binomial model), is recognized over the vesting period, and the total amount of compensation expense to be recognized is "fixed" at the grant date.

Under the federal tax laws, grants and exercises of stock options can have income tax consequences to companies and individuals alike. Tax benefits (deductions) for companies can arise from stock options. These implications are perhaps best illustrated in the context of the two common tax classifications of employee stock options – non-statutory stock options and incentive stock options. Incentive stock options are typically granted to executives whereas non-statutory stock options are typically granted to all types of employees, including executives, as well as others such as consultants and non-employee directors.

When an employee exercises non-statutory stock options, the difference between the exercise price and the fair market value of the company's stock on the date of exercise is treated as ordinary compensation, and the employee is generally taxed on the gain at his or her ordinary income tax rate. The employee is taxed at the exercise date because this is the date the employee is able to "realize" the benefit associated with the options; at that date, the employee received the proceeds from the options (either the underlying stock or cash, if the stock is immediately sold) and therefore becomes liable for income taxes. The company is also entitled to an associated tax deduction on the gain realized by the employee upon exercise. Since the tax deduction is tied to an option's

intrinsic value at the *exercise date*, that tax deduction will likely be different than the compensation expense recognized in the company's financial statements, which is based on the option's *fair value* at the *grant date*.[15] The company's tax deduction may be more or less than the compensation expense recognized in the financial statements – this depends entirely on the market price of the underlying stock on the date of exercise. Additionally, if the options expire out-of-the-money or underwater, the employee will not exercise the options and the company will not receive a tax deduction; however, the company will have recognized some amount of compensation expense in its financial statements under FAS 123R as long as the employee vests in the options.

Unlike non-statutory stock options, incentive stock options afford employees a more favorable tax treatment. Upon exercise of an incentive stock option, any gain is not taxed as ordinary income, although the gain may be subject to alternative minimum tax. Instead, the employee will be subject to long-term capital gains treatment when the underlying stock acquired through exercise is disposed of.[16] In this case, the employee's gain is not taxed as ordinary income; likewise, a company does not receive any corresponding tax deduction. However, many incentive stock options result in "disqualifying dispositions," in which the employee does not meet the minimum required holding periods because the underlying stock is sold the same day the option is exercised. In such cases, the options are treated as non-statutory stock options – the employee's gain will be taxed as ordinary income, and the company will receive a corresponding tax deduction.

The ability to deduct an employee's gain on non-statutory stock options when exercised may afford the company a favorable tax treatment (greater tax deduction) relative to the book compensation expense recognized in the financial statements in circumstances in which the market price of the company's stock rises at amounts greater than the grant-date fair value of the option. Indeed, under the Opinion 25 accounting standard, the difference between the accounting and tax treatment was even more pronounced since most companies did not recognize any stock option expense in their financial statements; and, as long as the non-statutory stock options were in-the-money and exercised, the tax deduction was always greater than the expense for those companies.

Backdated grants and backdated exercises of stock options also have tax implications. In the case of backdated grants of incentive stock options, grants purportedly made at the money would appear in fact to be in-the-money grants. If so re-characterized, they would appear not to qualify for the special tax treatment afforded incentive stock options and would instead be taxed as non-statutory options. This could result in additional taxes and penalties being due from the employee and have tax implications for the company as well, particularly if the options were originally claimed as exempt from the $1 million cap imposed by Section 162(m). Backdated exercise dates of both non-statutory options and incentive stock options may have tax implications for both employees and companies as well.

The discussion so far highlights the differences between the accounting for stock options and its tax treatment. In the deliberations leading to the issuance of FAS 123R,

the FASB considered a model in which the final measurement date for purposes of recognizing compensation expense would be the exercise date (i.e., variable accounting), which generally would result in the same total compensation expense as the company's tax deduction for non-statutory stock options. Advocates of this approach noted that any value the employee ultimately realizes upon exercise appropriately measures the amount of compensation paid, and argued therefore that final measurement would be more simple and straightforward since the final measure of compensation is simply the difference between the market price of the underlying stock and the exercise price at the date of exercise (or zero, if the options expire underwater). However, the FASB ultimately decided (consistent with the conclusion reached by the IASB in the standard I referred to earlier) that the compensation cost should be measured at the grant date, because that is the date the employer and employee mutually agree to the terms of the exchange of equity instruments for employee services. At that date, both parties are to base their decisions on the current fair value of the option to be exchanged, not its possible value at a future date. Any subsequent change in the value of the option is a risk the employee takes as an equity holder of the option, similar to the risk any other investor takes when purchasing an option, and that risk is factored into the fair value measurement of the option at the date of grant.

Comparison of Accounting and Tax Systems for Stock Options

Schedule M-3 is intended to make it possible for the first time to juxtapose the differences between financial statement and taxable income and the underlying transactions from which those differences arise. The data generated from the first batch of Schedules M-3 for 2004 show a sizeable differential between the compensation cost of stock options that corporations have expensed on their financial statements and the tax deductions that corporations have taken in connection with the stock option compensation they have granted to employees.

While I'd like to suggest that comparing the financial reporting and tax systems is a bit like comparing apples to oranges, it is more complicated than that. For the years prior to 2006, before FAS 123R was effective for most companies, the comparison was more like apples to automobiles. How a company calculated stock option compensation costs was based on a set of rules that differ significantly from those in place today. Before FAS 123R, most companies expensed options in accordance with Opinion 25, which in most cases meant that no expense was recognized because the option was granted at-the-money. This likely accounts for a large extent of the book-to-tax differential in 2004 (and 2005, when that data is available).

Comparing how a company calculates stock option compensation costs and tax deductions for those costs after FAS 123R takes us back to the apples to oranges analogy.

The compensation expense a company recognizes in its financial statements is tied to the fair market value of the option at the time of grant, whereas the tax deduction is tied to an option's intrinsic value at the exercise date. Depending on the market price of the underlying stock at the time of the option's exercise, the intrinsic value of the

option could be significant (in the case of a rising stock market) or minimal (in the case of a relatively static market).

The adoption of FAS 123R by most companies in 2006 will no doubt reduce the book-to-tax differential, but the magnitude and timing of this impact is difficult to predict. That is because, under FAS 123R, companies will recognize the expense associated with an option grant in the financial statements (amortized over the vesting period) prior to any tax deduction being reflected on exercise of that option. If the tax system for companies was changed to bring it into conformity with the financial reporting system, one effect would be to accelerate the timing of a company's tax deductions.

I very much appreciate the opportunity to appear before the Subcommittee today to provide the Commission's views on this important subject, and I would be happy to respond to any questions.

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[1] S*ee generally*, *e.g.*, Michael C. Jensen, Kevin J. Murphy and Eric G. Wruck, "Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them" (July 12, 2004). Harvard NOM Working Paper No. 04-28; ECGI – Finance Working Paper No. 44/2004. Available at SSRN: http://ssrn.com/abstract=561305 or DOI: 10.2139/ssrn.561305. *And see*, Lucian Arye Bebchuk and Yaniv Grinstein, "The Growth of Executive Pay" (June 2005). NBER Working Paper No. W11443. Available at SSRN: http://ssrn.com/abstract=752021. Bebchuk and Grinstein show that equity-based compensation comprised 55% of the total compensation paid to the top-five executives of the S&P 500 firms in 2003, up from 37% of the total compensation in 1993.

[2] Jensen, Murphy and Wruck, "Remuneration," at 35: "Executive remuneration in the U.S. has skyrocketed over the past thirty years, propelled in large part by increases in the grant-value of option awards."

[3] *See generally*, Christopher Cox, Chairman, U.S. Securities and Exchange Commission, "Testimony Concerning Options Backdating" before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Sept. 6, 2006), available at http://www.sec.gov/news/testimony/2006/ts090606cc.htm.

[4] Jensen, Murphy and Wruck, "Remuneration," at 26.

[5] *See* Cox Testimony at http://www.sec.gov/news/testimony/2006/ts090606cc.htm.

[6] *Id.* at 30.

[7] *See generally, e.g.*, Kevin J. Murphy, "Stock-Based Pay in New Economy Firms," Journal of Accounting & Economics, Vol. 34, Nos. 1-3, pp. 129-147 (Jan. 2003).

[8] *Id*. at 36.

[9] Jensen, Murphy and Wruck, "Remuneration," at 31.

[10] *Id*.

[11] *See, e.g.*, Porter, "More Than Ever, It Pays to be the Top Executive;" and Bebchuk and Grinstein, "The Growth of Executive Pay."

[12] *See* "Ownership Reports and Trading by Officers, Directors and Principal Security Holders," Release No. 34-46421 (Aug. 27, 2002) [67 FR 56461].

[13] Item 10 of Schedule 14A of the Securities Exchange Act of 1934 (17 CFR 240.14a-101).

[14] Options that did not qualify for "fixed" accounting treatment were accounted for as "variable" awards. Such options were generally re-measured for purposes of recognizing compensation expense to their current intrinsic value at each financial statement date.

[15] Prior to FAS 123R, the compensation expense recognized in the company's financial statements was typically the *intrinsic value* at the *grant date*.

[16] This tax treatment applies only if the options and employee meet certain holding and other requirements specified in IRS regulations. Among such requirements, the options cannot be granted in-the-money and the employee must meet certain minimum holding periods for the underlying stock (stock may not be disposed of within two years of grant date or within one year of the exercise date).