



Memorandum

September 22, 2003

TO: Honorable Frank Lautenberg
Attention: Dan Katz

FROM: American Law Division

SUBJECT: Official's Stock Options In and Deferred Salary From a Corporation as a
"Financial Interest" of an Executive Branch Official in Such Corporation

This memorandum responds to your request, as discussed with Dan Katz of your staff, for a discussion of whether or not the holding of unexercised stock options in a private corporation, and the receipt of "deferred salary" from that corporation, by an official in the executive branch of the United States Government, would generally be considered a "financial interest" of that official in that private corporation for conflict of interest and ethics purposes under federal law and regulation. You have inquired as to whether or not assigning to charities all after-tax profits from any exercise of the stock options in the corporation, and independently insuring the salary payments from the corporation, would change the conclusion as to the official's "financial interest" in the corporation in question.

The general, underlying principle of the conflict of interest laws adopted by Congress, and of the regulations promulgated in the executive branch, embodies the axiom "that a public servant owes undivided loyalty to the Government,"¹ and that decisions, advice and recommendations made by or given to the Government by its officers be made in the *public* interest and not be tainted, even unintentionally, with influence from *private* or personal financial interests.² The House Judiciary Committee, reporting out the major conflict of interest revisions made to federal law in the 1960's found:

The proper operation of a democratic government requires that officials be independent and impartial; that Government decisions and policy be made in the proper channels of the governmental structure; ... and that the public have confidence in the integrity of its government. The attainment of one or more of these ends is impaired whenever there

¹ H. R. Rpt. No. 748, 87th Congress, 1st Session, at 3 (1961). House Judiciary Committee report on the comprehensive amendments and revisions to conflict of interest laws in 1962.

² H. R. Rpt. No. 748, *supra* at 4-6; see also *United States v. Mississippi Valley Generating Co.*, 364 U.S. 520, 549 (1960); and Association of the Bar of the City of New York, *Conflict of Interest and Federal Service*, at 3-4 (1960).

exists, or appears to exist an actual or potential conflict between the private interests of a Government employee and his duties as an official.³

As noted in expert studies in the field of conflicts of interest, the concern in such regulation is generally:

not only the possibility or appearance of private gain from public office, but the risk that official decisions, whether consciously or otherwise, will be motivated by something other than the public's interest. The ultimate concern is bad government⁴

The conflict of interest laws are thus directed not only at conduct which is improper, but rather are often preventative or prophylactic in nature, directed at situations which merely have the *potential* to tempt or subtly influence an official in the performance of official public duties. As explained by the Supreme Court with regard to a predecessor conflict of interest law requiring disqualification of officials from matters in which they have a personal financial interest:

This broad proscription embodies a recognition of the fact that an impairment of impartial judgment can occur in even the most well-meaning men when their personal economic interests are affected by the business they transact on behalf of the Government.⁵

Under federal law and regulation there are three main methods of conflict of interest avoidance: disclosure, disqualification, and divestiture.

Disclosure. Detailed annual public financial *disclosure* is required for all high-level officials in all three branches of the United States Government under the public financial disclosure provisions of the Ethics in Government Act of 1978.⁶ Such disclosures were intended to serve the purpose of identifying "potential conflicts of interest or situations that might present the appearance of a conflict of interest" for Government officials in policy making positions.⁷

Under the disclosure law, assets "held for investment or the production of income,"⁸ as well as outside earned income (income from other than one's Government salary) received by the reporting individual are the types of financial interests that must be disclosed. Stock options are a "reportable property interest" in a corporation for which "description sufficient

³ H. R. Rpt. No. 748, *supra* at 4-6.

⁴ The Association of the Bar of the City of New York, Special Committee on Congressional Ethics, James C. Kirby, Executive Director, *Congress and the Public Trust*, 38-39 (1970).

⁵ *United States v. Mississippi Valley Generating Co.*, *supra* at 549, concerning 18 U.S.C. § 434 (1960 Code ed.), predecessor statute to current 18 U.S.C. § 208.

⁶ P.L. 95-521, as amended, *see now* 5 U.S.C. appendix, §§ 101 *et seq.*

⁷ S. Rpt. No. 95-170, 95th Cong., 1st Sess. 117 (1977). The fact that the disclosures were to be made public was also seen as serving the purpose of increasing public confidence in the integrity of the institutions of Government and in those who serve them.

⁸ U.S. Office of Government Ethics, *Public Financial Disclosure: A Reviewer's Reference*, at 3-7.

for conflict of interest review” must be provided by the reporting individual.⁹ Deferred salary or compensation received from a private corporation in the reportable year is considered as among the “ties” retained in or “linkages to former employers” that may “represent a continuing financial interest in those employers, which makes them potential conflicts of interest,” and must be disclosed as employment relationships and outside earned income.¹⁰ As noted by the Office of Government Ethics:

Filers may retain ties to a former employer in a number of ways, each of which they must list on the SF 278 [the standard form for executive branch financial disclosures]. One common linkage is a leave of absence, which many people take to retain a highly competitive position, such as a tenured faculty slot at a university. In addition, an employee may have other benefits from a former employer, such as *deferred compensation*, profit-sharing, *stock options*, employee pension, medical and insurance plans. Most of these linkages to former employers represent a continuing financial interest in those employers, which makes them potential conflicts of interest.¹¹

Unexercised stock options in a private corporation, as well as deferred salary currently received in the reporting year from a private corporation by a reporting official, are thus clearly items which are required to be disclosed under the public financial disclosure provisions, and are among those benefits described by the Office of Government Ethics as “retained ties” or “linkages” to one’s former employer, such that these items are reportable “financial interests” in such private corporation for the purposes of the financial disclosure provisions of the Ethics in Government Act of 1978. The fact that a deferred salary or compensation from a private corporation may be “insured,” and thus “guaranteed” regardless of the corporation’s performance, and the fact that the after-tax profits from the exercise of outstanding stock options that the official currently holds in the corporation have been designated to various charities, does not, in any of the literature, explanations or express rulings of ethics entities, take such official’s ties, interests and linkages to private corporations out of the realm of required financial disclosures for conflict of interest avoidance and identification purposes.

Disqualification and Divestiture. The principal statutory method of dealing with potential conflicts of interest of an executive branch officer or employee is to require the disqualification (or “recusal”) of the officer or employee from participating in any official governmental matter in which that official (or those persons or entities close enough to the official that their interests may be “imputed” to the official) has any “financial interest.”¹²

⁹ *Public Financial Disclosure: A Reviewer’s Reference*, *supra* at 3-7, and 8-7 to 8-8.

¹⁰ *Public Financial Disclosure: A Reviewer’s Reference*, *supra* at 6-5.

¹¹ *Id.* Emphasis added. Certain *pension* plans are not necessarily considered disqualifying financial interests in the former employer, such as would require recusal under 18 U.S.C. § 208, *see* OGE Memorandum, 99 x 6, to Designated Agency Ethics Officials, April 14, 1999, *re* “defined contribution plans.”

¹² 18 U.S.C. § 208 provides criminal penalties for “an officer or employee of the executive branch of the United States Government ... [who] participates personally and substantially as a Government officer or employee, through decision, approval, recommendation, the rendering of advice, investigation, or otherwise, in a judicial or other proceeding, application, request for a ruling or other determination, contract, claim, controversy, charge, accusation, arrest, or other particular matter in which, to his knowledge, he, his spouse, minor child, general partner, organization in which he is

This criminal statute requiring disqualification applies to all officers and employees in the executive branch and independent agencies, but expressly excludes the President and Vice President.¹³ There is no *de minimis* exception expressly stated in the statute for the value of an asset or ownership interest, but regulations may exempt certain categories of investments and interests which are deemed too remote or inconsequential to affect the performance of an official's governmental duties,¹⁴ and Office of Government Ethics regulations exempt several such interests in stocks, bonds, and mutual funds.¹⁵ Additionally, officers or employees of the Government may receive a written waiver from their employing authority to participate in a matter when the employee's interest is not deemed so substantial as to affect the integrity of the performance of his or her official duties.¹⁶

Additionally, under regulations promulgated by the Office of Government Ethics, recusal or disqualification may be required from a narrower range of official matters (narrower than the statutory recusal requirement), which may impact the financial interests of a broader range of persons or entities associated with the public official (a broader range of "imputed" persons than the statute includes).¹⁷ The regulations of the Office of Government Ethics provide this *regulatory* disqualification provision to help assure the avoidance of "an appearance of loss of impartiality in the performance of" official duties by a federal employee.¹⁸ The regulation requires a Government employee in the executive branch to recuse himself or herself from a "particular matter involving specific parties" when the employee knows that the matter will have a direct and predictable effect on the financial interests of a member of his or her household, or upon a person or entity with whom the employee has a "covered relationship," and where the employee believes that his or her impartiality may be questioned, unless the employee first advises his or her agency about the matter and receives authorization to participate in the matter.¹⁹ This regulation, like the

¹² (...continued)

serving as officer, director, trustee, general partner or employee ... has a financial interest ..."

¹³ 18 U.S.C. § 202(c). The President and Vice President are now expressly exempt by statute. Even before this express statutory exemption was enacted, however, the Department of Justice considered the President and Vice President, as elected constitutional officers of the Government, as exempt from the disqualification requirement since the *statutory* obligation to recuse could interfere with the performance of their *constitutionally* mandated duties. *Note* Department of Justice letter opinion to Senator Cannon, Chairman of the Senate Rules and Administration Committee, September 20, 1974, concerning the private ownership interests of vice presidential nominee Nelson Rockefeller.

¹⁴ 18 U.S.C. § 208(b)(2).

¹⁵ *De minimis* exemptions include securities, stocks and bonds in a publicly traded company which is a party to and directly affected by a governmental matter if one's ownership value is no more than \$15,000; securities, stocks and bonds in such a company which is not a specific party to a matter but is in a class affected by the governmental matter, if the employee's ownership interest is no more than \$25,000 (if securities in more than one such company are owned, then the aggregate value can not exceed \$50,000 to be exempt from the statute). 5 C.F.R. § 2640.202.

¹⁶ 18 U.S.C. § 208(b)(1).

¹⁷ 5 C.F.R. § 2635.502.

¹⁸ 5 C.F.R. § 2635.501(a).

¹⁹ 5 C.F.R. § 2635.502(a).

statutory recusal requirement expressly excludes the President and Vice President,²⁰ and may be waived for other officer and employees by supervisor personnel.²¹

There is no express statute that provides for or requires a general, or over-all “divestiture” of conflicting assets by high level Government officials. Divestiture, however, may be required by an agency (and may be part of an ethics agreement), and the requirement to divest is generally connected to the issue of required statutory disqualifications.²² Regulations promulgated by the Office of Government Ethics note that an agency may by regulation prohibit or restrict the ownership of certain financial assets or class of assets by its officers and employees where, because of the mission of the agency, such interests would “cause a reasonable person to question the impartiality and objectivity with which agency programs are administered.”²³ In such instances, these statutory and regulatory provisions would, in their effect, require the divestiture of particular assets and holdings of certain individuals to be appointed to such positions or who are incumbents in such positions. Additionally, under current regulations of the Office of Government Ethics, as part of the ethics review process, an agency may require the divestiture of certain assets of an individual employee where those interests would require the employee’s disqualification from matters so central to his or her job that it would impair the employee’s ability to do perform his or her duties, or where it could adversely affect the agency’s mission because another employee could not easily be substituted for the disqualified employee.²⁴

As far as stock options and disqualification and divestiture, stock options are clearly among the “financial interests” of an employee in an outside corporate entity which would normally trigger the required disqualification provisions for conflict of interest purposes under 18 U.S.C. § 208, when those options are valued above a *de minimis* amount.²⁵ Similarly, stock options would normally qualify as interests of, and make the employee’s relationship to the private outside corporation, a “covered relationship” under the regulatory recusal requirements of 5 C.F.R. § 2635.502, that is, a relationship with those persons or entities with whom the employee “has ... a business, contractual or other financial relationship that involves other than a routine financial consumer transaction.”²⁶

The Office of Government Ethics has thus expressly ruled that stock options are among those financial interests in private corporations that may be subject to divestiture requirements because of the potential on-going conflicts of interest and disqualifications that they may raise for federal officials.²⁷ It is not clear whether the assignment to charities of the

²⁰ 5 C.F.R. § 2635.102(h).

²¹ 5 C.F.R. § 2635.502(c), and (d).

²² The President and the Vice President are also exempt from the regulatory divestiture requirements, in a similar manner as they are from the disqualification provisions. 5 C.F.R. § 2635.102(h).

²³ 5 C.F.R. § 2635.403(a).

²⁴ 5 C.F.R. § 2635.403(b).

²⁵ 5 C.F.R. § 2640.202.

²⁶ 5 C.F.R. § 2635.502(b)(1)(i).

²⁷ Office of Government Ethics, Opinion 99 X 3, March 16, 1999. The gains from stock options may be considered, for tax purposes, as “salary incentives” and thus treated as earned income, or may merely be treated as capital gains. In either case such options appeared to be generally considered

profits from exercising such ownerships and assets would necessarily render the financial instruments themselves as a “non-disqualifying” interest, since the underlying current value of the options are not necessarily changed (and still increases as the stock of the company increases and decreases as the stock price of the company decreases), and the actual *ownership* of the underlying options remain in the name of and under the control of the federal official.²⁸ Even if not a “disqualifying” financial interest for the purposes of the criminal statute at 18 U.S.C. § 208, such options could still be a factor for *regulatory* disqualification as creating a “covered relationship” with such entity, that is, demonstrating that the officer, *vis-a-vis* this particular corporation, has a “business, contractual or other financial relationship that involves other than a routine consumer transaction.”²⁹ Furthermore, the assignment instrument would have to be examined to determine whether there is any residual ownership interest to the official after leaving office, or ultimately to the official’s estate. No specific published rulings were found on the subject of whether assigning the profits from the exercise of stock options would make such financial interests in the corporation a “non-disqualifying” financial interest for statutory and regulatory disqualification and divestiture purposes.³⁰ However, as noted, even if the underlying asset is not a “disqualifying” financial interest for purposes of the criminal *statute* when profits are assigned, it may still be one for the *regulatory* recusal requirement which has a broader range of interests and entities with whom the official is considered to have a “covered relationship.”

Deferred salary or compensation from a private corporate entity received by a federal official in the executive branch would also appear to normally trigger the disqualification requirements. However, since the compensation is already obligated for *past* services, in a somewhat similar manner as “pensions,” it is at least arguable that such deferred compensation should only trigger § 208 as a disqualifying financial interest when the matter concerned may reasonably affect the ability of the corporation to pay that salary. It should be noted that for purposes of the statutory disqualification requirement and *pensions*, the Office of Government Ethics would not consider a “defined contribution plan” pension as a “disqualifying” financial interest of the employee “because the sponsor is not obligated to fund the employee’s pension plan.”³¹ Even in the case of a “defined benefit plan” pension, where the employer *is* required to contribute to the retirement payments, such a pension

²⁷ (...continued)

“financial interests” of an executive branch official in the entity for which such options are held, such that, depending on the nature of the official duties of the federal officer, such stock options were the subject of a required divestiture to comport with federal conflict of interest provisions.

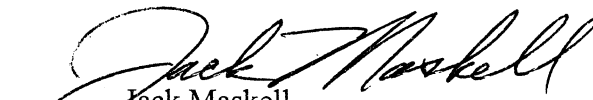
²⁸ The assignment of income, when it is the income itself that is prohibited (rather than the activity or the underlying income-producing asset), may satisfy applicable conflict of interest laws under certain circumstances and contingencies. See Office of Government Ethics, Advisory Opinion 99 x 20, Memorandum dated November 3, 1999, from Stephen D. Potts, Director, to Designated Agency Ethics Officials, Regarding Contingency Fees and 18 U.S.C. 203.

²⁹ 5 C.F.R. § 2635.502(b)(1)(i).

³⁰ But see footnote 27, above, and OGE opinion DO-99-042, November 3, 1999.

³¹ OGE Memorandum, 99 x 6, to Designated Agency Ethics Officials, April 14, 1999. It may be noted that stocks, bonds or other securities being held in an employee benefit plan or other retirement plan, such as an IRA or 401(k), are not disqualifying interests if the plan is “diversified,” as long as the plan is administered by an independent trustee and the employee does not choose the specific assets in the plan, and the plan is not a profit sharing or stock bonus plan. 5 C.F.R. § 2640.210(c).

would not implicate §208 unless the matter would be so significant as to affect the company's ability to pay.³² Thus, under this reasoning, insuring the deferred salary might take such financial interest outside of the statutory conflict of interest provision such that this particular interest in the company would not be one which is a *disqualifying* financial interest under 18 U.S.C. § 208. While the company remains obligated to pay the deferred compensation, the compensation is insured and thus the payment of the compensation will be made (similar to the case of a defined contribution plan) regardless of the company's ability to pay. The continued receipt of deferred salary or compensation, even when insured, would, however, arguably come within the broader range of those regulatory relationships and recusals, as creating a "covered relationship" between the officer and the corporation, since the official's relationship to the corporation paying him deferred salary would seem to constitute a "business, contractual or other financial relationship that involves other than a routine consumer transaction."³³



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³² *Id.*

³³ 5 C.F.R. § 2635.502(b)(1)(i).