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EXECUTIVE STOCK OPTIONS: SHOULD THE INTERNAL REVENUE SERVICE AND STOCKHOLDERS BE GIVEN DIFFERENT INFORMATION?

HEARING

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON
HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

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EXECUTIVE STOCK OPTIONS: SHOULD THE INTERNAL REVENUE SERVICE AND STOCKHOLDERS BE GIVEN DIFFERENT INFORMATION?

TUESDAY, JUNE 5, 2007

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
OF THE COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:02 a.m., in room SD–342, Dirksen Senate Office Building, Hon. Carl Levin, Chairman of the Subcommittee, presiding.

Present: Senators Levin and Coleman.

Staff Present: Elise J. Bean, Staff Director and Chief Counsel; Mary D. Robertson, Chief Clerk; John McDougal, Detailee, IRS; Guy Ficco, Detailee, IRS; Ross Kirschner, Counsel; Genevieve Citrin, Intern; Mark L. Greenblatt, Staff Director and Chief Counsel to the Minority; Mark D. Nelson, Deputy Chief Counsel to the Minority; Timothy R. Terry, Counsel to the Minority; Emily T. Germain, Staff Assistant to the Minority; Ruth Perez, Detailee, IRS; Kunaal Sharma, Intern; Adam Healey (Senator Tester); and Chris Pendergast (Senator Carper).

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Good morning, everybody. The Subcommittee will come to order, and what we would like to do is begin with a moment of silence in tribute to our friend and our colleague, Craig Thomas of Wyoming, who passed away yesterday after a courageous battle with leukemia. And I would ask everybody to stand for a moment in silence.

[Moment of silence.]

Senator LEVIN. Thank you.

The subject of today's hearing is executive stock options. Stock options give employees the right to buy company stock at a set price for a specified period of time, typically 10 years. Stock options are a key component of executive pay.

According to *Forbes* magazine, in 2006, the average pay of the chief executive officers (CEOs), of 500 of the largest U.S. companies was $15.2 million. Nearly half of that amount—$7.3 million—came from exercised stock options. On the high end, one CEO cashed in stock options for $290 million, another for $270 million. *Forbes* also published a list of 30 CEOs in 2006, who each had at least $100 million in vested stock options that had yet to be exercised.

J.P. Morgan once said that CEO pay should not exceed 20 times average worker pay. In the United States, in 1990, average CEO pay was 100 times average worker pay; in 2004, the figure was 300 times; today, it is nearly 400 times. Stock option grants to executives are a big part of the modern chasm between executive pay and the pay of average workers.

Stock options have been portrayed as a way to align corporate executives' interests with those of stockholders because they produce income for an executive only if the company's stock price rises. But stock options have also been associated with a litany of abuses ranging from dishonest accounting to tax dodging—from Enron, to the backdating scandal to the Wyly brothers in Texas, who, as our hearing showed last summer, tried to dodge U.S. taxes by sending $190 million in stock options to offshore shell companies that they secretly controlled.

Today's hearing is looking at a stock option issue that does not involve allegations of wrongdoing. Rather, today's hearing focuses on a set of mismatched accounting and tax rules that are legal. These rules require companies to report one set of stock option compensation figures to investors and the public on their books, and a completely different set of figures to the Internal Revenue Service (IRS) on their tax returns. In most cases, the resulting tax deduction has far exceeded the expense shown on the company books.

When a company's compensation committee learns that stock options often produce a low compensation cost on the books while generating a whopping tax deduction frequently, it is a pretty tempting proposition for them to provide their executives with large amounts of stock options. The problem is that the mismatch in stock option accounting and tax rules also shortchanges the Treasury to the tune of billions of dollars each year while fueling the huge gap between executive pay and average worker pay.

Calculating the cost of stock options may sound straightforward, but for years companies and their accountants engaged the Financial Accounting Standards Board (FASB), in an all-out, knock-down battle over how companies should record stock option compensation expenses on their books. In the end, FASB issued a new accounting rule, Financial Accounting Standard (FAS) 123R, which was endorsed by the SEC and became mandatory for all publicly traded corporations in June 2005. In essence, that rule requires all companies to record a compensation expense equal to the fair value on grant date of stock options provided to employees in exchange for their services.

Opponents of the new accounting rule predicted that it would severely damage U.S. capital markets. They warned that stock option expensing would eliminate profits, discourage investment, depress stock prices, and stifle innovation. Last year, 2006, was the first year in which all U.S. publicly traded companies were required to expense stock options. Instead of tumbling, both the New York Stock Exchange and NASDAQ turned in strong performances, as did initial public offerings by new companies. The dire predictions were wrong.

In contrast to the battle raging over stock option accounting, relatively little attention was paid to the taxation of stock options. Section 83 of the Tax Code, first enacted in 1969, is the key statutory provision. It essentially provides that when an employee exercises stock options, the employee must report as income the difference between what the employee paid to exercise the options and the market price of the stock received. The corporation can then take a mirror deduction in the same amount as a compensation expense.

For example, suppose an executive had options to buy one million shares of company stock at $10 per share. Suppose 5 years later the executive exercised the options when the stock was selling at $30 per share. The executive's income would be $20 per share, for a total of $20 million. The executive would declare $20 million as ordinary income, and in the same year the company would take a corresponding tax deduction of $20 million.

Although in 1993, Congress enacted a $1 million cap on the compensation that a corporation can deduct from its taxes so taxpayers would not be forced to subsidize millions of dollars in executive pay, an exception was made for stock options, allowing companies to deduct any amount of stock option compensation without limit.

The stock option accounting and tax rules now in place are at odds with each other. Accounting rules require companies to expense stock options on the grant date. Tax rules require companies to deduct stock option expenses on the exercise date. Companies have to report the grant date expenses to investors on their financial statements and exercise date expenses on their tax returns. The financial statements report on all stock options granted during the year, while the tax returns report on all stock options exercised during the year. In short, company financial statements and tax returns report expenses for different groups of stock options using different valuation methods, resulting in divergent stock option expenses for the same year.

Now, to test just how far these figures diverge, the Subcommittee contacted a number of companies to compare the stock option expenses that they reported for accounting and for tax purposes. The Subcommittee asked each company to identify stock options that had been exercised by one or more of its executives from 2002 to 2006. The Subcommittee then asked each company to identify the compensation expense that they reported on their financial statements versus the compensation expense on their tax return. In addition, we asked the companies' help in estimating what effect the new accounting rule would have had on their book expense if it had been in place when their stock options were granted. And we very much appreciate the cooperation and the assistance which has been provided by the nine companies whose data is being disclosed today, particularly including the companies that were asked to testify. We are grateful to all of them for their cooperation and for their information, and we are particularly, again, grateful to the three companies who are before us today to provide us with that information.

The data showed that under then existing accounting rules, the nine companies generally showed stock options as a zero expense on their books. The one exception was Occidental Petroleum, which in 2005, began voluntarily expensing its options and recorded an expense for a few options. When the Subcommittee asked the companies what their book expense would have been if the new FASB rule had been in effect, all nine calculated a book expense that remained dramatically lower than their tax deductions.

The chart which I am putting now before us, Exhibit 1,[1] shows the book-tax differences, using the book expense calculated under the new FASB rule. It shows that the nine companies alone produced $1 billion more in tax deductions than the expense shown on their books, even using the tougher new accounting rule. There tax deductions far exceeded their book expenses, not because the companies were doing anything wrong, but because the current stock option accounting and tax rules are so out of whack.

KB Home, for example, is a company that builds residential homes. Its stock price has more than quadrupled over the last 10 years. Over the same period, it repeatedly granted stock options to its then-CEO. Company records show that over the past 5 years, KB Home gave him 5.5 million stock options, of which he exercised more than 3 million.

With respect to those 3 million stock options, KB Home recorded a zero expense on its books. Now, had FASB's new rule been in effect, KB Home calculated that it would have reported on its books a compensation expense of about $11.5 million. KB Home also disclosed that the same 3 million stock options enabled it to claim compensation expenses on its tax returns totaling about $143.7 million. In other words, KB Home claimed a $143 million tax deduction for expenses that on its books under current accounting rules, the new accounting rules, would have totaled $11.5 million. That is a tax deduction 12 times bigger than the book expense.

Occidental Petroleum, the next company on the chart, disclosed a similar book-tax discrepancy. This company's stock price has also skyrocketed in recent years, dramatically increasing the value of the 16 million stock options granted to its CEO since 1993. Of the 12 million stock options the CEO actually exercised over the past 5 years, Occidental Petroleum claimed a $353 million tax deduction for a book expense that under current accounting rules would have totaled just $29 million. That is a book-tax difference of more than 1,200 percent.

Similar book-tax discrepancies apply to the other companies that we contacted. Cisco Systems' CEO exercised nearly 19 million stock options over the past 5 years and provided the company with a $169 million tax deduction for a book expense which under current accounting rules would have totaled about $21 million.

UnitedHealth's former CEO exercised over 9 million stock options in 5 years, providing the company with a $318 million tax deduction for a book expense which would have totaled about $46 million.

Safeway's CEO exercised over 2 million stock options, providing the company with a $39 million tax deduction for a book expense which would have totaled about $6.5 million.

Altogether these nine companies took stock option tax deductions totaling $1.2 billion—a figure five times larger than their combined

[1] See Exhibit 1 which appears in the Appendix on page 236.

stock option book expenses of $217 million. The resulting $1 billion book-tax difference represents a huge tax deduction windfall for the companies simply because they issued lots of stock options to their CEOs. Tax rules that produce outsized tax deductions that are many times larger than the related stock option book expenses give companies an incentive to issue huge stock option grants because they know that the stock options can produce a relatively small hit to profits and probably a much larger tax deduction that can dramatically lower their taxes.

To gauge just how big the tax gap is for stock options, the Subcommittee asked the IRS to perform an analysis of its overall data on stock option book-tax differences. The new Schedule M–3, which went into effect last year for large corporations, asked companies to identify differences in how they report corporate income to investors versus what they report to Uncle Sam. The resulting M–3 data applies mostly to 2004 tax returns.

The IRS found that corporations took tax deductions on their tax returns for stock option compensation expenses which were $43 billion greater than the stock option expenses shown on their financial statements for the same year. Those massive tax deductions enabled corporations as a whole to legally reduce their taxes by billions of dollars, perhaps by as much as $15 billion.

When asked to look deeper into who benefited from the stock option deductions, the IRS was able to determine that the entire $43 billion book-tax difference was attributable to about 3,200 corporations nationwide, of which about 250 companies accounted for 82 percent of the total difference. In other words, a relatively small number of corporations were able to generate a $43 billion tax deduction by handing out substantial stock options to their executives.

The current differences between stock option accounting and tax rules make no sense. They require companies to show one stock option expense on their books and a completely different expense on their tax returns. They allow companies to take tax deductions that overall are many times larger than the stock option expenses shown on their books, which not only shortchanges the Treasury but also provides an accounting and tax windfall to companies giving out huge stock options and creates an incentive for companies to keep right on giving out those options.

The book-tax difference is fueling an ever deepening chasm between executive pay and the pay of average workers. The stock option book difference is a historical product of accounting and tax policies that have not been coordinated or integrated. Right now stock options are the only compensation expense where companies are allowed to deduct much more on their tax returns than the expense shown on their books. And I emphasize that is the only compensation expense where that is allowed.

In 2004, companies used the book-tax difference to claim $43 billion more in stock option deductions than the expenses shown on their books. We need to examine whether we can afford this multibillion-dollar loss to the Treasury, not only in light of the deep Federal deficits but also in light of the evidence that this stock option book-tax difference is contributing to the gap, the growing gap, between the pay of executives and the pay of average workers.

In past years, I have introduced legislation to require stock option deductions to match the stock option expenses shown on company books. I hope our witnesses today will indicate whether they agree that Federal tax policy should be brought into line with accounting policy and provide that corporations deduct on their tax returns only the amount of stock option expenses that is shown on their books.

[The prepared statement of Senator Levin follows:]

PREPARED STATEMENT OF SENATOR LEVIN

The subject of today's hearing is executive stock options. Stock options give employees the right to buy company stock at a set price for a specified period of time, typically 10 years. Stock options are a key contributor to executive pay.

According to *Forbes* magazine, in 2006, the average pay of the chief executive officers (CEOs) of 500 of the largest U.S. companies was $15.2 million. Nearly half of that amount, 48 percent, came from exercised stock options that produced average gains of about $7.3 million. On the high end, one CEO cashed in stock options for $290 million, another for $270 million. Forbes also published a list of 30 CEOs in 2006, who each had at least $100 million in vested stock options that had yet to be exercised. J.P. Morgan once said that CEO pay should not exceed 20 times average worker pay. In the United States, in 1990, average CEO pay was 100 times average worker pay; in 2004, the figure was 300 times; today, it is nearly 400 times.

Stock options have been portrayed as a way to align corporate executives' interests with those of stockholders, because they produce income for an executive only if the company stock price rises. But stock options have also been associated with a litany of abuses ranging from dishonest accounting to tax dodging—from Enron, to the backdating scandal, to the Wyly brothers in Texas who, as our hearing showed last summer, tried to dodge U.S. taxes by sending $190 million in stock options to offshore shell companies they secretly controlled.

Today's hearing is looking at a stock option issue that does not involve allegations of wrongdoing. Rather, today's hearing focuses on a set of mismatched accounting and tax rules that are legal. These rules require companies to report one set of stock option compensation figures to investors and the public on their books, and a completely different set of figures to the Internal Revenue Service (IRS) on their tax returns. In most cases, the resulting tax deduction has far exceeded the expense shown on the company books.

When a company's compensation committee learns that stock options often produce a low compensation cost on the books, while generating a whopping tax deduction, it's a pretty tempting proposition for them to pay their executives with stock options instead of cash or stock. The problem is that the mismatch in stock option accounting and tax rules also shortchanges the Treasury to the tune of billions of dollars each year, while fueling the growing chasm between executive pay and average worker pay.

Accounting Battle. Calculating the cost of stock options may sound straightforward, but for years, companies and their accountants engaged the Financial Accounting Standards Board in an all-out, knock-down battle over how companies should record stock option compensation expenses on their books.

U.S. publicly traded corporations are required by law to follow Generally Accepted Accounting Principles (GAAP), issued by the Financial Accounting Standards Board (FASB), which is overseen by the Securities and Exchange Commission (SEC). For many years, GAAP allowed U.S. companies to issue stock options to employees and, unlike any other type of compensation, report a zero compensation expense on their books, so long as, on the grant date, the stock option's exercise price equaled the market price at which the stock could be sold.

Assigning a zero value to stock options that routinely produced millions of dollars in executive pay provoked deep disagreements within the accounting community. In 1993, FASB proposed assigning a "fair value" to stock options on the date they are granted to an employee, using a mathematical valuation tool such as the Black Scholes model, and then including a grant date expense on companies' financial statements. Critics responded that it was impossible accurately to estimate the value of executive stock options on their grant date. A bruising battle over stock option expensing followed, involving the accounting profession, corporate executives, FASB, the SEC, and Congress.

In the end, FASB issued a new accounting standard, Financial Accounting Standard (FAS) 123R, which was endorsed by the SEC and became mandatory for all publicly traded corporations in June 2005. In essence, FAS 123R requires all companies to record a compensation expense equal to the fair value on grant date of stock options provided to employees in exchange for their services.

The details of this accounting rule are complex, because they reflect an effort to accommodate varying viewpoints on the true cost of stock options. Companies are allowed to use a variety of mathematical models, for example, to calculate a stock option's fair value. Option grants that vest over time are expensed over the specified period so that, for example, a stock option which vests over four years results in 25% of the cost being expensed each year. If a stock option grant never vests, the rule allows any previously booked expense to be recovered. On the other hand, stock options that do vest must be fully expensed, even if never exercised, because the compensation was actually awarded. These and other provisions of this hard-fought accounting rule reflect painstaking judgements on how to show a stock option's true cost.

Opponents of the new accounting rule predicted that it would severely damage U.S. capital markets. They warned that stock option expensing would eliminate profits, discourage investment, depress stock prices, and stifle innovation. Last year, 2006, was the first year in which all U.S. publicly traded companies were required to expense stock options. Instead of tumbling, both the New York Stock Exchange and Nasdaq turned in strong performances, as did initial public offerings by new companies. The dire predictions were wrong.

Tax Treatment. In contrast to the battle raging over stock option accounting, relatively little attention was paid to the taxation of stock options. Section 83 of the tax code, first enacted in 1969, is the key statutory provision. It essentially provides that, when an employee exercises stock options, the employee must report as income the difference between what the employee paid to exercise the options and the market value of the stock received. The corporation can then take a mirror deduction for the same amount of income.

For example, suppose an executive had options to buy 1 million shares of company stock at $10 per share. Suppose, five years later, the executive exercised the options when the stock was selling at $30 per share. The executive's income would be $20 per share for a total of $20 million. The executive would declare $20 million as ordinary income, and in the same year, the company would take a corresponding tax deduction for $20 million. Although in 1993, Congress enacted a $1 million cap on the compensation that a corporation can deduct from its taxes, so taxpayers wouldn't be forced to subsidize millions of dollars in executive pay, an exception was made for stock options, allowing companies to deduct any amount of stock option compensation, without limit.

Book-Tax Differences. The stock option accounting and tax rules now in place are at odds with each other. Accounting rules require companies to expense stock options on the grant date. Tax rules require companies to deduct stock option expenses on the exercise date. Companies have to report grant date expenses to investors on their financial statements, and exercise date expenses on their tax returns. The financial statements report on all stock options granted during the year, while the tax returns report on all stock options exercised during the year. In short, company financial statements and tax returns report expenses for different groups of stock options, using dramatically different valuation methods, resulting in widely divergent stock option expenses for the same year.

Company Data. To test just how far these figures diverge, the Subcommittee contacted a number of companies to compare the stock option expenses they reported for accounting and tax purposes. The Subcommittee asked each company to identify stock options that had been exercised by one or more of its executives from 2002 to 2006. The Subcommittee then asked each company to identify the compensation expense they reported on their financial statements versus the compensation expense on their tax returns. In addition, we asked the companies' help in estimating what effect the new accounting rule would have had on their book expense if it had been in place when their stock options were granted. We very much appreciate the cooperation and assistance provided by the nine companies whose data is being disclosed today, including the three companies that were asked to testify.

The data showed that, under then existing accounting rules, the nine companies generally showed stock options as a zero expense on their books. The one exception was Occidental Petroleum which, in 2005, began voluntarily expensing its options and recorded an expense for a few options. When the Subcommittee asked the companies what their book expense would have been if the new FASB rule had been in effect, all nine calculated a book expense that remained dramatically lower than their tax deductions.

This chart, which is Exhibit 1, shows the book-tax differences, using the book expense calculated under the new FASB rule. It shows that the nine companies alone produced $1 billion more in tax deductions than the expense shown on their books, even using the tougher new accounting rule. Their tax deductions far exceeded their book expenses, not because the companies were doing anything wrong, but because the current stock option accounting and tax rules are so out of whack.

KB Home, for example, is a company that builds residential homes. Its stock price has more than quadrupled over the past 10 years. Over the same time period, it repeatedly granted stock options to its then CEO. Company records show that, over the past five years, KB Home gave him 5.5 million stock options of which he exercised more than 3 million.

With respect to those 3 million stock options, KB Home recorded a zero expense on its books. Had FAS 123R been in effect, KB Home calculated that it would have reported on its books a compensation expense of about $11.5 million. KB Home also disclosed that the same 3 million stock options enabled it to claim compensation expenses on its tax returns totaling about $143.7 million. In other words, KB Home claimed a $143 million tax deduction for expenses that on its books, under current accounting rules, would have totaled $11.5 million. That's a tax deduction 12 times bigger than the book expense.

Occidental Petroleum, the next company on the chart, disclosed a similar book-tax discrepancy. This company's stock price has also skyrocketed in recent years, dramatically increasing the value of the 16 million stock options granted to its CEO since 1993. Of the 12 million stock options the CEO actually exercised over the past five years, Occidental Petroleum claimed a $353 million tax deduction for a book expense that, under current accounting rules, would have totaled just $29 million. That's a book-tax difference of more than 1200%.

Similar book-tax discrepancies apply to the other companies we contacted. Cisco System's CEO exercised nearly 19 million stock options over the past five years, and provided the company with a $169 million tax deduction for a book expense which, under current accounting rules, would have totaled about $21 million. UnitedHealth's former CEO exercised over 9 million stock options in five years, providing the company with a $318 million tax deduction for a book expense which would have totaled about $46 million. Safeway's CEO exercised over 2 million stock options, providing the company with a $39 million tax deduction for a book expense which would have totaled about $6.5 million.

Altogether, these nine companies took stock option tax deductions totaling $1.2 billion, a figure five times larger than their combined stock option book expenses of $217 million. The resulting billion-dollar book-tax difference represents a huge tax deduction windfall for the companies simply because they issued lots of stock options to their CEOs. Tax rules that produce outsized tax deductions that are many times larger than the related stock option book expenses give companies an incentive to issue huge stock option grants, because they know the stock options will produce a relatively small hit to profits and a much larger tax deduction that can dramatically lower their taxes.

To gauge just how big the tax gap is for stock options, the Subcommittee asked the IRS to perform an analysis of its overall data on stock option book-tax differences. The new M-3 Schedule, which went into effect last year for large corporations, asked companies to identify differences in how they report corporate income to investors versus what they report to Uncle Sam. The resulting M-3 data applies mostly to 2004 tax returns.

The IRS found that stock option compensation expenses were one of the biggest factors in the difference between book and tax income reported by U.S. corporations. The data shows that, in 2004, stock option compensation expenses produced a book-tax gap of about $43 billion, which is about 30% of the entire book-tax difference reported for the period. That means, as a whole, corporations took deductions on their tax returns for stock option compensation expenses which were $43 billion greater than the stock option expenses shown on their financial statements for the same year. Those massive tax deductions enabled the corporations, as a whole, to legally reduce their taxes by billions of dollars, perhaps by as much as $15 billion.

When asked to look deeper into who benefitted from the stock option deductions, the IRS was able to determine that the entire $43 billion book-tax difference was attributable to about 3,200 corporations nationwide, of which about 250 corporations accounted for 82% of the total difference. In other words, a relatively small number of corporations was able to generate a $43 billion tax deduction by handing out substantial stock options to their executives.

There are other surprises in the data as well. One set of issues involves unexercised stock options which, under the new accounting rule, will produce an expense on the books but no tax deduction. Cisco told the Subcommittee, for example, that in addition to the 19 million exercised stock options mentioned a moment ago, their CEO holds about 8 million options that, due to a stock price drop, would likely expire without being exercised. Cisco calculated that, had FAS 123R been in effect, the company would have had to show a $139 million book expense for those options, but would never be able to claim a tax deduction for them since they would never be exercised. Apple pointed out that, in 2003, it allowed its CEO to trade 17.5 million in underwater stock options for 5 million shares of restricted stock. That trade meant the stock options would never be exercised and so would never produce a tax deduction. In both cases, under FAS 123R, it is possible that stock options would produce a reported book expense greater than a company's tax deduction. While the M-3 data suggests that, overall, accounting expenses lag far behind claimed tax deductions, the possible financial impact on an individual company of a large number of unexercised stock options is additional evidence that stock option accounting and tax rules are out of kilter.

Another set of issues has to do with how the corporate stock option tax deduction depends upon decisions made by individual corporate executives on whether and when to exercise their stock options. Normally, a corporation dispenses compensation to its employees and takes a tax deduction in the same year for the expense. With respect to stock options, however, corporations may have to wait years to see if, when, and how much of a deduction can be taken. UnitedHealth noted, for example, that it gave its former CEO 8 million stock options in 1999, of which, by 2006, only about 730,000 had been exercised. It does not know if or when it will get a tax deduction for the remaining 7 million options.

If the rules for stock option tax deductions were changed so that the annual deduction matched the expenses shown on a company's books in the same year, companies could take the deduction years earlier, without waiting for exercises, and it would allow companies to deduct stock options that vest but are never exercised. It would treat stock options in the same manner as every other form of corporate compensation by allowing a deduction in the same year that the compensation was granted.

Conclusion. The current differences between stock option accounting and tax rules make no sense. They require companies to show one stock option expense on their books and a completely different expense on their tax returns. They allow companies to take tax deductions that, overall, are many times larger than the stock option book expenses shown on their books, which not only shortchanges the Treasury, but also provides an accounting and tax windfall to companies doling out huge stock options, and creates an incentive for companies to keep right on doling out those options. The book-tax difference is fueling an ever deepening chasm between executive pay and the pay of average workers.

The stock option book-tax difference is a historical product of accounting and tax policies that have not been coordinated or integrated. Right now, stock options are the only compensation expense where companies are allowed to deduct much more on their tax returns than the expense shown on their books. In 2004, companies used the book-tax difference to claim $43 billion more in stock option deductions than the expenses shown on their books. We need to examine whether we can afford this multi-billion dollar loss to the Treasury, not only in light of the deep federal deficits, but also in light of evidence that this stock option book-tax difference is contributing to the growing gap between the pay of executives and the pay of average workers.

In past years, I've introduced legislation to require stock option tax deductions to match the stock option expenses shown on the company books. I hope the witnesses today will help us analyze the policy issues, and indicate whether they agree that federal tax policy should be brought into line with accounting policy, and provide that corporations deduct on their tax returns only the amount of stock option expenses shown on their books.

Senator LEVIN. Senator Coleman.

OPENING STATEMENT OF SENATOR COLEMAN

Senator COLEMAN. Thank you. Thank you, Mr. Chairman. I want to thank you for initiating this investigation and for the dedicated focus and long effort you have given to ensure that investors in America's publicly traded companies have full access to important information regarding executive compensation.

I have a longer statement that I would like entered into the record, Mr. Chairman, but let me discuss perhaps three issues in my opening.

First, why are we concerned? The Chairman has detailed the explosion of executive pay. In 2006, CEOs earned almost 400 times the wage of the typical rank-and-file employee, and while it is said that exceptional performance demands exceptional pay, it is troubling when mediocrity is rewarded with a king's ransom. But why are we in government concerned about this? One of the concerns is that this excess, including the exorbitant severance packages paid to executives ejected from their companies, at times under cloud of scandals, robs shareholders of earnings that are rightfully theirs and draws on the retirement savings of America's hard-working families.

Without a closer link to performance, extraordinary CEO pay packages threatens to undermine the average investor's trust in our markets. More than 80 percent of Americans and 90 percent of institutional investors, including pension and retirement funds, think CEOs of large companies are overpaid. More disturbing, 60 percent of corporate directors—the very people who determine executive pay—believe CEOs of large companies make more than they deserve. Warren Buffett once argued that CEO pay "remains the acid test" to judge whether corporate America is serious about reform. If so, the results so far are anything but encouraging. Ultimately, some semblance of reality should be restored to executive pay.

There was a column yesterday in the *Minneapolis Star Tribune,* one of my hometown papers, by Charles Denny, a former CEO, and he noted that "our Nation's great wealth is a product of free market capitalism operating within, and ultimately governed by, the political system of democracy." And what Mr. Denny offers—and it was a very timely piece—is unique insight in concluding that if the current corporate excesses "continue unchecked, the electorate's support of the political/economic concept of democratic capitalism will be severely tested." I share Mr. Denny's concern, and if the business community does not do something soon, companies are going to get more pressure from the Federal Government and from Congress in particular.

So how did we get here? Clearly, there are a number of factors that have propelled executive salaries into the stratosphere. First, it cannot be overlooked that as CEO salaries have grown over the past 25 years, so too has the average size of large American companies. Indeed, the companies that will testify today exemplify this important point, as they have all produced substantial increases in profits over the past 15 years, much to the benefit of their shareholders. Moreover, the competition for high-performing CEOs is higher than ever, and the costs associated with recruiting and retaining top managers have bid up the compensation packages for all executives. That said, the pink elephant in the room is the stock option. When one considers the numbers that Senator Levin mentioned in his opening statement—that in 2004, stock options resulted in a book-tax gap of $43 billion—it becomes clear that the impact of stock options on executive compensation cannot be overstated.

In fact, for the past 15 years, executive pay has been defined by the option. In 1992, for example, Standard & Poor's 500 companies issued only $11 billion in stock options. In the year 2000, when option compensation reached its peak, companies issued options worth more than $119 billion. And although somewhat abated, companies still issued tens of billions of dollars' worth of stock options last year.

To be clear, stock options are valuable and legitimate incentive tools, and the increased use of stock-based compensation reflects a logical attempt by publicly traded companies to align the self-interests of their executives with the best interests of the shareholders. By replacing cash with long-term incentives, stock options are meant to make managers think like owners and ensure that executive pay is linked to company performance. And during the early 1990s, options worked as intended—executive pay increased as shareholders profited.

But in the overvalued market of the late 1990s, it became clear that the link between performance and pay had grown tenuous at best. As the bull market charged, it seemed that executives got rich just by showing up for work, and investors began to deride stock options as "pay for pulse." Worse, executive decisionmaking seemed more short term than ever. Earning manipulations in Enron, WorldCom, and elsewhere underscored what many investors already feared; stock options provided company managers with perverse incentives to personally profit from artificial, even fraudulent, inflation of share values.

The intent behind stock-based compensation—to align managers' and shareholders' interests and to reward and retain high-performing executives—is noble, but anything can be destructive in excess. The meteoric rise in executive pay, especially where undeserved, has caused shareholders to complain that companies issued far too many stock options on terms that were far too generous. Options often vest too quickly, rarely include true performance hurdles, and upon exercise, shares can frequently be sold without restriction.

Regrettably, Congress must take some blame for this excessive and at times unwarranted executive compensation. We changed the rules. In 1993, as the Chairman mentioned, Congress attempted to rein in executive pay by enacting Section 162(m) of the Tax Code. This section limits to $1 million the tax deductions companies can take for salaries of their top executives. Congress did not, however, extend this cap to stock option pay, and almost immediately companies shifted to this fully deductible and, therefore, cheaper form of compensation. As a result, when the stock market booms, as it did during the early 1990s and the last few years, total executive compensation skyrockets, often regardless of executive performance.

To make this point clear, consider that in 1994, 1 year after Section 162(m) was passed, the average CEO was earning $1.7 million in total compensation, including about $680,000 from stock option exercises. By 2004, CEO compensation had risen by more than 400 percent, to more than $7 million annually. Notably, more than three-quarters of that compensation, or more than $5 million, came from stock options. In other words, Congress' attempt to limit executive salaries had just the opposite effect. As Chairman Cox of the SEC, who will testify later this morning, recently told another Senate committee, Section 162(m) "deserves pride of place in the museum of unintended consequences." For the record, I agree with Chairman Cox.

So where do we go from here? Well, the good news is the climate is changing. The Chairman noted that FAS 123R is in place. It has provided some long overdue reform. Before it became effective in 2005, accounting rules—contrary to economic logic—did not require companies to report the cost of stock options to investors, but under the new rule, companies must now subtract the total value of stock option compensation from their financial earnings. This corrects a longstanding and poorly conceived policy that required companies to hide the true cost of stock option compensation from their investors while reporting that amount to the IRS in order to claim a tax deduction.

This point bears repeating. As Senator Levin noted earlier, most companies that report large book-tax gaps for stock options do so simply because different tax and accounting rules require them to do so. Although it is too early to assess the full impact of FAS 123R, it is already clear that companies are issuing fewer stock options, requiring longer vesting and holding periods, and hopefully setting truer performance benchmarks. So it is hoped that as a result of FAS 123R, the book-tax gap should narrow.

I am concerned, however, that while the book-tax gap for stock options is closing, the information gap for executive pay remains much too large. Too often, shareholders are left in the dark regarding how much their top executives really make. And even when this information is disclosed, shareholders still have little, usually no input into executive compensation. Equally troubling, shareholders often perceive that the so-called independent directors who set executive salaries have cozy relationships with the CEO, often to the detriment of the investors they are supposed to represent. In an environment that allows collegiality to trump independence, investor confidence can and will be undermined.

It is, therefore, imperative that companies take steps to ensure that top executives' pay is fair and deserved. In doing so, I encourage the industry that often reminds us that the market, not the government, should set prices to practice what it preaches. This requires that companies open their compensation decisions to shareholder scrutiny. Companies must provide clear, plain-English disclosures of CEO pay to their investors and encourage more contact between independent directors and shareholders. Moreover, companies should consider submitting executive pay to shareholder votes, or even allowing shareholders to vote on the directors themselves. In this way, the interaction between the investors and directors will take place before lawsuits and proxy fights and in the form of constructive negotiation rather than costly litigation.

I should add that I am encouraged by the SEC's new rules that require proxy statements to include summary tables and plain-language disclosures of top executives' pay. But more work remains to ensure that investors receive full, easily digestible disclosures of executive compensation. Shareholders cannot be left to believe that the executive pay game is rigged against them. Executive pay must be determined by those it affects, and where poor performance has distorted compensation, companies must act quickly to put things right. If they do not, I can assure that this will not be the last congressional hearing on executive pay.

You will note, Mr. Chairman, that my focus here is on shining a light on what is going on, giving investors information. I do worry, as we move forward, that we avoid unintended consequences, that we avoid the danger of repeating what we did in 1993 as we moved into this area. Clearly, the gap is real. It is there. I would note, however, that on the total reported tax deduction, the companies take. The individual is paying taxes on that amount, so the government is getting some compensation there. When you look at some of the best-growing companies, if the market were to go down, would the proposed rule changes have the same effect? Or, in fact, if we have companies taking deductions up front and then the options never vested, would we be giving companies a tax break, a shadow tax break, for which the IRS would never get the revenue?

So as we move forward, let us be clear as to what the consequences are. I do think there is a responsibility that the corporate community has not responded to. And so I thank the Chairman for this hearing, and I look forward to the testimony.

I have two meetings that I have to attend, Mr. Chairman, but I will be coming back. Thank you.

[The prepared statement of Senator Coleman follows:]

OPENING STATEMENT OF SENATOR COLEMAN

Thank you for attending today's hearing. I want to thank this Subcommittee's Chairman, Senator Levin, for initiating this investigation and I want to commend him on his many years of dedicated focus on this issue. Today's hearing continues your long effort to ensure that investors in America's publicly traded companies have full access to important information regarding executive compensation.

For the past 25 years, the pay checks cashed by America's top executives have grown exponentially. During the 1990s in particular, executive pay exploded to unprecedented levels, and by 2002, the average American worker earned in a year what the average CEO took home every evening. Last year alone, CEOs at America's 500 largest companies earned an average of $15.2 million apiece—a staggering increase of almost 40 percent from just the year before.

It seems inconceivable that in 2006 CEOs earned almost 400 times the wage of the typical rank-and-file employee. And while it is often said that exceptional performance demands exceptional pay, it is troubling when mediocrity is rewarded with a king's ransom. There are far too many examples of excessive pay for poor performance, of executives and their families receiving millions of dollars in undisclosed company perks, and of exorbitant severance packages paid to executives who have been ejected from their companies under the cloud of scandal. Such excess robs shareholders of earnings that are rightfully theirs and draws on the retirement savings of America's hard-working families.

Without a closer link to performance, extraordinary CEO pay packages threaten to undermine the average investor's trust in our markets. More than 80 percent of Americans and 90 percent of institutional investors'including pension and retirement funds—think CEOs of large companies are overpaid. More disturbing, 60 percent of corporate directors—the very people who determine executive pay—believe CEOs of large companies make more than they deserve. Warren Buffet once argued that CEO pay "remains the acid test" to judge whether corporate America is "serious" about reform. If so, the results so far are anything but encouraging. Ultimately, some semblance of reality must be restored to executive pay.

I am concerned by the widening loss of confidence in the business community. Charles Denny, who is a former CEO, noted in an article that ran yesterday in one of my home town newspapers, the Star Tribune, that "[o]ur nation's great wealth is the product of free-market capitalism operating within, and ultimately governed by, the political system of democracy." As a former CEO, Denny offers unique insight in concluding that if current corporate excesses "continue unchecked, the electorate's support of the political/economic concept of democratic capitalism will be severely tested." I share Mr. Denny's concern, and if the business community doesn't do something soon, companies are going to get more pressure from the Federal Government and from Congress in particular.

So how did we get here? Obviously, a number of factors have propelled executive salaries into the stratosphere. First, it cannot be overlooked that, as CEO salaries have grown over the past 25 years, so too has the average size of large American companies. Indeed, the companies that will testify today exemplify this important point—as they have all produced substantial increases in profits over the past 15 years, much to the benefit of their shareholders. Moreover, the competition for high-performing CEOs is higher than ever, and the costs associated with recruiting and retaining top managers have bid up the compensation packages for all executives. That said, the pink elephant in the room is the stock option. When one considers the numbers that Senator Levin mentioned in his opening—that in 2004, stock options resulted in a book-tax gap of $43 billion—it becomes clear that the impact of stock options on executive compensation cannot be overstated.

In fact, for much of the last 15 years, executive pay has been defined by the option. In 1992, for example, S&P 500 companies issued only $11 billion in options. In 2000, when option compensation reached its peak, companies issued options worth more than $119 billion. And although somewhat abated, companies still issued tens of billions of dollars worth of stock options last year.

To be clear, stock options are valuable and legitimate incentive tools. And the increased use of stock-based compensation reflects a logical attempt by publicly traded companies to align the self-interests of their executives with the best interests of their shareholders. By replacing cash with long-term incentives, stock options are meant to make managers think like owners and ensure that executive pay is linked to company performance. And, during the early 1990s, options worked as intended—executive pay increased as shareholders profited.

But in the overvalued market of the late 1990s, it became clear that the link between performance and pay had grown tenuous at best. As the bull market charged, it seemed that executives got rich just by showing up for work, and investors began to deride stock options as "pay for pulse." Worse, executive decision making seemed more short-term than ever. Earnings manipulations at Enron, Worldcom, and elsewhere underscored what many investors already feared; stock options provided company managers with perverse incentives to personally profit from artificial, even fraudulent, inflation of share values. The intent behind stock-based compensation—to align managers' and shareholders' interests and to reward and retain high performing executives—is noble, but anything can be destructive in excess. The meteoric rise in executive pay, especially where undeserved, has caused shareholders to complain that companies issued far too many stock options on terms that were far too generous. Options often vest too quickly, rarely include true performance hurdles, and upon exercise, shares can too frequently be sold without restriction.

Regrettably, Congress must take some of the blame for this excessive, and at times unwarranted, executive compensation. In 1993, Congress attempted to rein in executive pay by enacting Section 162(m) of the tax code. This section limits to $1 million the tax deductions companies' can take for the salaries of their top executives. Congress did not, however, extend this cap to stock option pay, and almost immediately companies shifted to this fully deductible, and therefore cheaper, form of compensation. As a result, when the stock market booms, as it did during the 1990s and in the last few years, total executive compensation skyrockets, often regardless of executive performance.

To make this point more clear: Consider that in 1994, 1 year after Section 162(m) was passed, the average CEO earned about $1.7 million in total compensation, including approximately $680,000 from stock option exercises. By 2004, average CEO compensation had risen by more than 400 percent, to more than $7 million annually. Notably, nearly three-quarters of that compensation, or more than $5 million, came from stock options. In other words, Congress' attempt to limit executives' salaries has had just the opposite effect. As Chairman Cox of the SEC, which will testify later this morning, recently told another Senate committee, Section 162(m) "deserves pride of place in the museum of unintended consequences." For the record, I agree with Chairman Cox, as long as that museum is the hall of fame.

So where do we go from here? Well, the good news is that the climate surrounding executive pay is already beginning to change. FAS 123R, a recent change to the accounting rules for stock options, has provided long overdue reform. Before FAS 123R became effective in 2005, accounting rules—contrary to economic logic—did not require companies to report the costs of stock options to their investors. Under the new rule, companies must now subtract the total value of stock option compensation from their financial earnings. This corrects a long standing, and poorly conceived, policy that required companies to hide the true cost of stock option compensation from their investors, while reporting that amount to the IRS in order to claim a tax deduction.

This point bears repeating. As Senator Levin stated earlier, most companies that report large book-tax gaps for stock options do so simply because different tax and accounting rules require them to do so. Although it is still too early to assess the full impact of FAS 123R, it is already clear that companies are issuing fewer stock options, requiring longer vesting and holding periods, and hopefully setting truer performance benchmarks. Moreover, although differences between the tax rules and accounting rules governing stock options remain, now that every option issued represents a direct hit to the company's bottom line, the $43 billion book-tax gap that existed in 2004 should narrow significantly.

I am concerned, however, that while the book-tax gap for stock options is closing, the information gap for executive pay remains. Too often, shareholders are left in the dark regarding how much their top executives really make. And even when this information is disclosed, shareholders still have little, and usually no, input into executive compensation. Equally troubling, shareholders often perceive that the so-called independent directors who set executive salaries have cozy relationships with the CEO, often to the detriment of the investors they are supposed to represent. In an environment that allows collegiality to trump independence, investor confidence is undermined.

It is therefore imperative that companies take steps to ensure that top executives' pay is fair and deserved. In so doing, I encourage the industry that often reminds us that the market, not the government, should set prices, to practice what it preaches. This requires that companies open their compensation decisions to shareholder scrutiny. Companies must provide clear, plain-English, disclosures of CEO pay to their investors, and encourage more contact between independent directors and shareholders. Moreover, companies should consider submitting executive pay to shareholder votes, or even allowing shareholders to vote on the directors themselves. In this way, the interaction between investors and directors will take place before lawsuits and proxy fights, and in the form of constructive negotiation rather than costly litigation. I should add that I am encouraged by the SEC's new rules that require proxy statements to include summary tables and plain-language disclosures of top executives' pay. But more work remains to ensure that investors receive full, easily-digestible disclosures of executive compensation. Shareholders cannot be left to believe that the executive pay game is rigged against them. Executive pay must be determined by those it affects, and where poor governance has distorted compensation, companies must act quickly to put things right. If they don't, I can assure that this will not be the last Congressional hearing on executive pay.

In closing, I would like to thank each of the witnesses that are here today. I look forward to your testimony.

Senator LEVIN. Thank you so much, Senator Coleman.

Let us now welcome our first panel to this morning's hearing: Stephen Bollenbach, Chairman of the Board of Directors for KB Home; John Chalsty, Chairman of the Compensation Committee for Occidental Petroleum Corporation; and William Tauscher, member and former Chairman of the Compensation Committee for Safeway. We welcome you to the Subcommittee, gentlemen. Pursuant to Rule 6, all witnesses who testify before the Subcommittee are required to be sworn, and at this time I would ask all of you to please stand and raise your right hand.

Do you swear that the testimony you will give this morning before this Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. BOLLENBACH. I do.

Mr. CHALSTY. I do.

Mr. TAUSCHER. I do.

Senator LEVIN. We are using a timing system today, and 1 minute before the red light comes on, you will see the light change from green to yellow, which will give you an opportunity to conclude your remarks, and your written testimony, of course, will be printed in the record in its entirety. We would ask that you limit your oral testimony to no more than 5 minutes.

Again, we thank each of you and your companies for providing us with the information that we have requested. It is very important and useful to us, and, Mr. Bollenbach, we will have you go first, followed by Mr. Chalsty and then Mr. Tauscher.

TESTIMONY OF STEPHEN F. BOLLENBACH,[1] CHAIRMAN, BOARD OF DIRECTORS, KB HOME, LOS ANGELES, CALIFORNIA

Mr. BOLLENBACH. Good morning, Chairman Levin. My name is Stephen Bollenbach, and I recently joined KB Home as the first non-executive chairman of the board. I am currently CEO of Hilton Hotels Corporation as well as co-chairman of the board of that company. On behalf of KB Home and its 4,500 employees nationwide and its thousands of subcontractors doing business with the company, I would like to thank you for the opportunity to appear here today.

Before I turn to matters raised by the Subcommittee, I would like to introduce you briefly to KB Home. This year, we are proud to be celebrating 50 years of building quality homes, a story that began with two visionaries from Detroit—Eli Broad and Donald Kaufman. They established this company to serve the needs of entry-level housing with homes that are well designed and affordable. Fifty years later, we have developed over 1.5 million—for 1.5 million families we have developed homes. They come from all walks of life, but with a focus on first-time homeowners, we have been able to make the dream of homeownership possible for young families, immigrants, minorities, and in the high-cost metropolitan areas of America, for teachers, nurses, firemen, policemen, and other folks otherwise priced out of the communities in which they work. Last year, about 40 percent of the families who came to KB Home were buying their first home, and 66 percent were minorities. Continuing our tradition of civic engagement, KB Home is the only national home building company to have come to New Orleans following Hurricane Katrina. We have made nearly a $20 million investment in Louisiana.

Now let us turn from the business of KB Home and to the business of this meeting. I will speak to two issues: The accounting issues and the recent changes at KB Home.

First the issues related to accounting. I want to stress that KB Home has no view on the accounting and tax treatment of stock options. We have taken no position on this issue, and we really do not expect to. We will follow whatever rules are in effect, and we follow them as they change from time to time.

With that, I think the Subcommittee should understand that KB Home tax-books differential on the chart that we saw a minute ago is due to the extraordinary business performance of the company and the very large increase in its stock price between 2000 and 2005. During that time KB Home's stock price increased 600 percent. Over the same period, the S&P 500 managed to increase only .002 of 1 percent. If KB Home's stock price had merely performed as the S&P 500 had performed, our tax-book differential would have been negligible.

[1] The prepared statement of Mr. Bollenbach appears in the Appendix on page 55.

Recent corporate changes at KB Home. KB Home has made a number of corporate changes in the past 6 months following a comprehensive independent investigation into its stock option practices. That investigation discovered that in certain instances our former CEO and the head of Human Resources picked stock option grants using hindsight. As a result of that investigation, both our former CEO and the head of Human Resources have left the company.

KB Home also restated its financial statements to reflect an additional $41 million in compensation expense plus related tax charges over 6 years. While $41 million is a lot of money, to put that number in perspective KB Home's net income over the same period was nearly $3 billion. Of more importance for the future of KB Home, our Board of Directors took strong and swift action to reform the company's compensation and governance practices. The board separated the position of CEO from the chairman of the board, eventually selecting me as KB Home's first non-executive chairman. Our directors used to be elected for 3-year terms; now they are elected for 1-year terms. The employment agreement we recently signed with our new CEO embodies the best practices in the compensation area.

The board made other governance changes in the process, more than doubling the ISS corporate governance rating. Among companies in our industry, our rating is now in the 97th percentile. KB Home, like other home builders, is currently operating in a very challenging environment. We have worked diligently to put the issues of the last several months behind the company. Its employees and many of its shareholders can look forward to the future, and so KB Home can continue helping Americans achieve the dream of homeownership.

So thank you for giving me the opportunity to make this statement on behalf of KB Home, and I will attempt to answer any questions you may have.

Senator LEVIN. Thank you very much, Mr. Bollenbach. Mr. Chalsty.

TESTIMONY OF JOHN S. CHALSTY,[1] CHAIRMAN, EXECUTIVE COMPENSATION AND HUMAN RESOURCE COMMITTEE, OCCIDENTAL PETROLEUM CORPORATION, LOS ANGELES, CALIFORNIA

Mr. CHALSTY. My name is John Chalsty. I have spent most of my professional career working in investment banking and finance. From 1986 to 2000, I served as Chief Executive Officer and then Chairman of DLJ. In connection with my service on the Occidental's board, I currently serve as Chairman of Occidental's Executive Compensation and Human Resources Committee. I would like to make two important points.

First, the Compensation Committee only grants stock options pursuant to plans that have been approved by Occidental's shareholders, and the company fully discloses to its stockholders the granting of such stock options as required by law and regulation. The granting of stock options to officers and employees is a long-

[1] The prepared statement of Mr. Chalsty appears in the Appendix on page 60.

standing practice well understood by the company's stockholders, who have seen the management transform and refocus the company from 1990 to 2006. During that period, the company has increased core profits from $191 million to more than $4.3 billion, reduced debt by 65 percent from more than $8 billion, and increased its stock market value by 650 percent to $41 billion. Occidental's transformation increased the oil and gas sales from 17 percent of total sales in 1990 to 72 percent in 2006. The use of stock options, which align the interests of management and stockholders, as a part of the company's compensation program is not a surprise to the stockholders, the investment community, the regulators, or the public.

Second, throughout this period the company's treatment of stock options for both tax and accounting purposes complied fully with all applicable laws, rules, and regulations, and no one has contended otherwise. No stock options were backdated. No restated SEC financial statement filings have been required in the last 15 years.

Occidental has complied fully with all Federal, State, local, and foreign tax laws. The result of this compliance with the law has been that over the past 5 years, from 2002 to 2006, Occidental has paid more than $4 billion in corporate income taxes in the United States. In sum, Occidental is a successful U.S. company that complies fully with the law and pays substantial taxes.

As the Subcommittee has requested, I would like to provide a brief overview of Occidental's policies and procedures for granting stock options. Stock options are granted by the Compensation Committee, which is composed entirely of independent directors. The Compensation Committee may, as it deems appropriate, engage special legal or other consultants to report directly to the committee.

All new stock plans and amendments to existing stock plans must be reviewed by the Compensation Committee before being submitted to Occidental's Board of Directors for approval. In making its recommendation to the Board of Directors, the Compensation Committee takes into consideration the potential dilutive effect of such awards, as well as changes in compensation practices. New stock plans must first be approved by stockholders before they can be implemented.

The Compensation Committee grants stock awards at regularly scheduled meetings. No stock options granted by Occidental have ever been backdated.

Accordingly, the intrinsic value of the options on the date of the grant is zero. The plans do not permit re-pricing of options without the approval of stockholders, and Occidental has not re-priced any options. The stock options granted by Occidental vest one-third each year over a 3-year vesting period, are exercisable for a 10-year term, and are subject to forfeiture. In making grants to the executive officers, the Compensation Committee considers personal performance, industry practices, prior award levels, outstanding awards, and overall stock ownership in an effort to foster a performance-oriented culture and to align the interests of executive officers with the long-term interests of the company and its stockholders.

Occidental complies fully with both the accounting and tax rules with respect to stock options. From an accounting perspective, pursuant to FAS 123R, on July 1, 2005, Occidental began recognizing fair-value compensation. Compensation is measured using the Black-Scholes option.

With reference to Occidental's Federal tax returns, in accordance with IRS regulations, Occidental has reported deductions in its corporate tax returns for non-qualified stock options in the year they were exercised. For non-qualified stock options, the amount of Occidental's corporate tax deduction is the same as the amount included in taxable income by the exercising executives on their individual Federal income tax returns—that is, the difference between the fair market price and the option exercise or strike price. Any variations in these two numbers are the result of a difference between the applicable accounting and tax regulations.

The accounting rules and the tax rules are designed to pursue different objectives using different approaches with frequently different results. I cannot say that one is "right" and the other "wrong". What I can say with certainty is that Occidental has complied, and will comply, with whatever accounting and tax regulations the respective accounting and tax standard setters apply to the granting and exercising of stock option awards. Thank you.

Senator LEVIN. Thank you very much, Mr. Chalsty. Mr. Tauscher.

TESTIMONY OF WILLIAM Y. TAUSCHER,[1] MEMBER AND FORMER CHAIRMAN, COMPENSATION COMMITTEE, SAFEWAY, INC., PLEASANTON, CALIFORNIA

Mr. TAUSCHER. Thank you, Chairman Levin. I am William Y. Tauscher, and I am appearing today on behalf of Safeway. I have been a member of the Board of Directors of Safeway since 1998 and also a member of Safeway's Executive Compensation Committee since 1998. I served as Chair of the Executive Compensation Committee from 1998 until 2006. Besides being a Safeway Director, I am the Chairman and Chief Executive Officer of Vertical Communications, a public communications technology company, and I have previously been Chairman and Chief Executive Officer of Vanstar, a national computer services company, and before that Chairman and Chief Executive Officer of FoxMeyer, another public nationwide health care distributor.

Safeway is one of the largest food and drug retailers in North America, operating approximately 1,750 stores in the United States and Canada. Our revenues in 2006 were $40 billion, and we have about 200,000 employees. We have received a number of national recognition awards in environmental sustainability and social responsibility. We received a corporate governance rating of 93.1 from Institutional Shareholder Services. The company has also been instrumental in advancing important public policy discussions. Safeway has recently taken a lead position among American businesses to advance health care reform, building a coalition of nearly 50 large companies.

[1] The prepared statement of Mr. Tauscher appears in the Appendix on page 63.

Our compensation program has been instrumental to our success. Safeway's Executive Compensation Committee has designed its compensation program to attract and retain the best management. Our compensation program closely links the compensation of company executives with the company's financial performance and substantially aligns that compensation with the long-term interests of the shareholders. Because of that linkage, our board has been able to retain for nearly 15 years one of the best CEOs in corporate America.

Under Steve Burd's leadership, the company has outperformed 97 percent of the companies listed in the S&P 500 over the last 14.5 years he has served. The compound annual growth rate of Safeway's stock price over this time period, at 19.8 percent, has been twice that of the S&P 500. Safeway has outperformed many outstanding U.S. companies during this period. From 1992 to 2006, the company's market capitalization increased from $1.3 billion to $15.2 billion. The Company's annual earnings per share during that period increased from 9 cents to $1.94. These are extraordinary accomplishments considering the maturity of the sector and the nature of its competition. This has been accomplished, by the way, while helping the communities we serve by donating or raising more than $1.25 billion in cash or goods, or 18 percent of net income, to charitable organizations.

The company's recent performance has been excellent. In 2006, the return on investment in our stock was 47 percent, about 3 times the 15.8 percent return experienced by the S&P 500. An article in *Bloomberg News* last month noted that Safeway's performance since 2004 was better than 75 percent of the companies in the S&P 500, and in 2006 was in the 94th percentile.

We compete with a peer group of companies and numerous other companies for executive talent and, therefore, we need to pay, we believe, at market levels. The task for the Compensation Committee is to keep an eye on compensation levels at comparable companies and determine how to reward for extraordinary results. At Safeway, the Committee intentionally sets executive salary levels below market and uses bonuses and stock options to provide compensation slightly above competitive norms when the company performs well. Even given the recent success of the company, Mr. Burd's compensation has been within the lower range of large companies in the United States. In fact, his total compensation ranks in the bottom 10 percent of the companies in the S&P 100—we are about in the middle of that group from a size standpoint—and his equity compensation ranks in the bottom 5 percent of that group.

Because of the company's success over the past 10 to 15 years, Mr. Burd's stock options have increased in value, and he has been rewarded along with other investors in Safeway's stock. Unlike many other CEOs, Mr. Burd behaved like a long-term stockholder, typically holding his options until the end of the option period—historically, 10 to 15 years. By doing so, he has missed out on opportunistic peaks in the share price. This practice has also caused options to produce gains at a single point in time rather than spread out over many years, and these gains may not coincide with good performing years for the company. For example, Mr. Burd's 2003 and 2004 option exercises occurred at relatively low price points for the company's stock. This was not an opportune time to exercise, but the terms were expiring. When looking at these blocks of exercised options, it is important to consider them as 10-year compensation instruments and not associate them with 1 year's performance in the year of exercise.

Much of the criticism leveled at executive compensation these days relates to extraordinarily large severance packages that are given to CEOs upon their departure. Safeway is proud of the fact that none of its executive officers has an employment contract or a severance agreement. The CEO and other executive officers serve at the will of the board. If our CEO was terminated for any reason, we would have no obligation to pay him any severance.

With respect to the accounting rules, Safeway adopted FAS No. 123R, the accounting rule governing the expensing of stock options, in the first quarter of 2005. With the advice of expert consultants, Safeway has used the Black-Scholes methodology for valuing options for expense purposes, by far the most commonly used methodology for this purpose.

We understand the Subcommittee is examining several issues at this hearing, including how a company's accounting expense for stock options, determined using Black-Scholes or other options valuation methodologies, compares with the tax deductions a company takes when those options are exercised. We have three quick principal observations.

First, we believe any evaluation of the accounting expense for stock options should appropriately focus on all option grants, not merely option exercises. A snapshot comparing the accounting expense for exercised stock options to subsequent tax deductions for specific option exercises will result in a distorted picture. For example, such a comparison will not account for the expensed amounts on options that are never exercised because they expire with the exercise price higher than the company's current stock price. Thus, such a snapshot might exaggerate what seems, at first, to be a disparity between the accounting expense and the tax deductions.

Second, we believe the Subcommittee should assess this issue across a broad range of companies. The disparity between accounting expense and tax deductions will be greatest in companies that have outperformed their historical performance, like the group gathered here. By contrast, the accounting expense may significantly exceed tax deductions in companies that have underperformed their historical performance. A more accurate assessment of this issue requires an examination of numerous companies—outperformers and underperformers.

Finally, third, the Subcommittee, we believe, should not view the exercise of an option in a particular year as compensation simply for that year. When an option is exercised, the executive will receive the benefit of the appreciation in the value of the stock since the grant of the option. This may represent compensation for the executive's service for many years, possibly a decade or more, especially when the executive exercises the option at the end of the option period. As I have already commented, the extraordinary growth in Safeway's stock value from 1992 through 2006 resulted in a very significant value for options granted early in that period.

This extraordinary increase in value is properly viewed as the result of more than 10 years of effort to improve stockholder value.

I hope Safeway's participation today helps illuminate these accounting and tax policy rules for the Subcommittee, and I stand ready to answer questions.

Thank you, Mr. Chairman.

Senator LEVIN. Thank you, Mr. Tauscher. Let me start with you, Mr. Tauscher, and work the other way. Take a look at Chart 1,[1] if you would, in your book. According to the data that Safeway provided to the Subcommittee, the total amount deducted by Safeway on its tax returns for stock options exercised by the chief executive officer between 2002 and 2006 was $39 million. Is that figure accurate?

Mr. TAUSCHER. Yes, Mr. Chairman, it is.

Senator LEVIN. And because the options exercised in those years were granted before accounting rules required an accounting expense to be taken on your books, the company took no book expense for any of those options at that time. Is that correct?

Mr. TAUSCHER. Yes, Mr. Chairman, that is correct as well.

Senator LEVIN. Now, your company also did a computation at the Subcommittee's request—and we appreciate your doing so—of what the expense would have been booked for those options if the new Financial Accounting Standard had been in effect during those years, and the total book charge would have been about $6.5 million. Is that correct?

Mr. TAUSCHER. That is also correct.

Senator LEVIN. All right. So in your case, options with a $6.5 million book expense under today's rules would produce a tax deduction six times that amount. Is that correct?

Mr. TAUSCHER. That is correct.

Senator LEVIN. Now, in the Occidental Petroleum case, Mr. Chalsty, the options granted to your CEO would have caused a book expense under the new rules of about $29 million and ultimately generate total tax deductions for the company on exercise of those options of about $353 million. Is that correct?

Mr. CHALSTY. Yes, sir.

Senator LEVIN. And the deduction is about then 12 times the book expense. Is that correct?

Mr. CHALSTY. Yes.

Senator LEVIN. Mr. Bollenbach, KB Home's CEO exercised stock options between 2002 and 2006 that the new accounting rules would have required to be expensed on the company books at a total of $11.5 million while the tax rules allowed it to deduct almost $144 million or over 12 times the book expense. Is that correct?

Mr. BOLLENBACH. Yes, sir.

Senator LEVIN. Let me ask each of you whether or not at the time you award options and issue these options you are aware of the fact that there is a potentially greater tax deduction available to the corporation than the book value of those options. Is that something you are aware of, Mr. Bollenbach?

[1] The chart referred to appears in the Appendix on page 236.

Mr. BOLLENBACH. Yes. We understand the rules both from the accounting standpoint and from the tax standpoint, we understand that they are different and there will, therefore, be differences.

Senator LEVIN. And that there is at least a potential—and you hope a great potential because you hope the company will be profitable—that the tax deduction that will be available will be significantly greater than the book number that is shown?

Mr. BOLLENBACH. I think that what the company and the directors think about is that they need to comply—and they have no choice. They need to comply with two sets of rules, and that is simply the result of the set of rules. I do not think there is any other thoughts around that.

Senator LEVIN. So you are not aware of the fact when you issue options that if the company does well, which is your hope, that you will have a significant tax deduction upon the exercise of those options? That is not something you think about, a tax deduction for your own company?

Mr. BOLLENBACH. It is not something that I would think about in the context of the stock options, but I agree with you that, given what you have said, if the company performs well and its stock goes up, then there will be potentially a tax deduction that is larger than the accounting charge that was booked. Yes, I am aware of that.

Senator LEVIN. But you are saying that is not something that goes through your mind when you decide to issue large numbers of stock——

Mr. BOLLENBACH. It is not in my mind, it is not a tax planning——

Senator LEVIN. Is it, as far as you know, in any of the company personnel's mind?

Mr. BOLLENBACH. I do not know what is——

Senator LEVIN. You do not know. Mr. Chalsty, is that something in your mind?

Mr. CHALSTY. No, it is not, and I do not know if it is in any others' minds. I am aware that any reported—any excess of tax deduction of total expense is, of course, offset by the recipient, who pays taxes on exactly the same amount.

Senator LEVIN. So in terms of the company tax bill, you are saying that the award of stock options in large numbers that could potentially and hopefully from a company's perspective, because it wants to be very profitable, result in a large tax deduction but without any similar number being taken from the bottom line on the books is not something which goes through your mind?

Mr. CHALSTY. No, it does not. We are a Compensation Committee.

Senator LEVIN. All right. Mr. Tauscher, is that something which goes through your mind?

Mr. TAUSCHER. I can honestly tell you that in all the time of doing this, I have never thought about the tax deduction as some kind of corporate benefit for what we are doing. We literally are trying to design a program first that we test against market; second, we hope the company outperforms and the option outperforms. There is no question, though, that under the current way the rules work, if the company outperforms, as these three companies have, there will be a larger tax deduction than the book accounting that is set now under the new FASB rules. That is just a fact.

Senator LEVIN. Are you aware——

Mr. TAUSCHER. When we sit and plan for that, we are not sitting and talking about a great tax deduction. We are talking about motivating a chief executive for a great result.

Senator LEVIN. I am sure of that. But is there not a secondary benefit, a huge benefit, in terms of tax deductions for the company if the company performs well? The more profitable a company is, the more its stock goes up, the more valuable that stock option is when it is cashed in, the greater the tax deduction instead of taxes being paid commensurate with greater profitability as to the stock option. I know companies pay taxes based on profits, but the exercise of that option reduces the taxes, and the greater the profits, the greater the number of options, if they have been issued, the greater the deduction.

Mr. TAUSCHER. All of that is absolutely true, Mr. Chairman. The only comment I would add to that is I do not think we look at it terribly differently than if there was some kind of incentive bonus program that was paid in cash, the company did very well, the employee would get a cash bonus, the cash bonus would be deductible, the employee would pay tax on it. So the same thing is happening here.

Now, whether that is causing a certain behavior, I can only tell you again it is not contemplated as part of the activity that is going on here.

Senator LEVIN. Have you ever issued bonuses in this amount, cash bonuses contingent——

Mr. TAUSCHER. No, I have not.

Senator LEVIN. Contingent on performance.

Do you, Mr. Chalsty, if cash bonuses contingent on performance have ever been issued in this amount?

Mr. CHALSTY. No, we have not.

Senator LEVIN. Mr. Bollenbach.

Mr. BOLLENBACH. I am not aware of them.

Senator LEVIN. Thank you. Senator Coleman.

Senator COLEMAN. Thank you, Mr. Chairman.

I want to focus, if I can, on transparency, but I want to go back to Mr. Tauscher's comments first.

In effect, in 1993 when Congress limited compensation to the $1 million figure, stock options really then became the preferred choice of compensation. Would you agree that the growth in stock options or the use of stock compensation was a direct result of the law in 1993, which basically allowed you to issue options that did not show up on the company's books at that point in time as any expense, but at the same time it was a way to provide, obviously, compensation for executives and it worked out rather well? Is there any question about cause and effect between 1993 accounting changes and the growth of stock options?

Mr. TAUSCHER. Well, Senator Coleman, I do not draw as direct a connection, though I will say to you, without question, that when the base salary all of a sudden had limits in terms of tax deductibility and the other forms of compensation did not, I am sure that it had an effect. I am not sure it was sort of a direct thing where people said, OK, we have to issue a lot more stock options now because we have a limit on base salary. But it had to have some connection, without question.

Senator COLEMAN. And in part of your fiduciary responsibility, you want to show growth in the company. If there are those things that are going to impact perceived growth and you can legally avoid that, there is no nefarious purpose here. We simply set in place a process that limited executive compensation in one area, but did not limit it in the other, and if you want to compensate people, I presume you followed the law. Is that right?

Mr. TAUSCHER. That is right. But I think there is also a factor here that stock options tend to make executives look longer term. They are more strategic. They align them more, at least in the view of our Compensation Committee, with the shareholders as opposed to short-term compensation. Of course, base salary has no incentive or no performance part to it. So I think there was some of that at work as well.

Senator COLEMAN. And I think we are in agreement here, but I will express my concern that we are only looking at high-performing companies here. We also have to look at options that are not exercised. Among the proposals that folks have looked at is to equalize book value and tax value in year one, so companies would get their deductions right up front. But then in the end, if the options are not exercised, if the stock goes down, your company would have received a deduction but the IRS would have nothing because they are never getting taxes from the executive on option's if they are not exercised. They are not getting any tax revenue from that. So that would be a concern, which you mention in your point about bringing all the companies in to the equation. Here we have high-performing companies. They have done well. We have this graph. And clearly these companies have outperformed and have strong performance. If you bring in a low performer, however, one whose options are not exercised, then, in fact, IRS, the government, would lose in that example.

So I understand, and I am very concerned about this law of unintended consequences. I really do believe that in 1993 we made a mistake. And in the zeal to say we are going to put a lid on executive compensation, it is kind of like squeezing a balloon. You squeeze it on one end, and it pops out on the other.

On the other hand, I am deeply concerned about the public perception of executive pay. You have all these stories of, as I said before, pay for pulse, not pay for performance. So to me the issue becomes one of transparency. Can we get investors more involved in these things? Can we do things to heighten the level of public confidence? Because I think there is a consequence if we lose that public confidence.

Congress is considering a bill that would require publicly traded companies to give shareholders an advisory vote on corporate compensation committees. I have read that a number of companies are out in front of this proposed legislation and are already considering adopting such proposals voluntarily. To all three of you gentlemen, have your companies considered doing so? Why or why not? Mr. Bollenbach.

Mr. BOLLENBACH. We have looked at that and have not adopted that at this point. I think if it becomes a general practice of industry we would adopt such a policy.

Senator COLEMAN. Any benefits or negatives to it? What is your reaction to it? Rather than just following the herd, is there a sense that this would be a positive or negative?

Mr. BOLLENBACH. Well, for me, personally, I think it has both the potential to be positive in terms of making more public the compensation, and it has the possibility of being negative because I am concerned about special interest groups that really do not represent the shareholders, might have a very small holding and be vocal at meetings and vote against it. So I think it has both potential for good things and bad things.

Senator COLEMAN. Mr. Chalsty.

Mr. CHALSTY. We have not adopted that. We have, however, looked at it, and we are also, as Mr. Bollenbach says, holding a watching brief, if you will, on what happens. I do not really see that too much is to be gained by it, but we will watch and see what happens.

Senator COLEMAN. Mr. Tauscher.

Mr. TAUSCHER. I think we are pretty much in the same position, Senator. We do have a practice, however, that we have initiated in the last few years of going out to our largest shareholders and informally talking about aspects of our various compensation programs, and that does help in that you can get specific discussions on specific issues rather than sort of a broad reach thing that may be difficult to interpret. We have found that to be a good practice.

Senator COLEMAN. My last comment in this round. My sense is that folks are cautious and kind of seeing which way the herd is going. I would urge you gentlemen to figure out a way to get ahead of the pack, because Congress will herd you in a direction because the shareholders, our constituents, are upset. They cannot understand these widening gaps. They cannot understand the pay-for-pulse mentality. And I would urge you, rather than kind of see which way the wind is blowing, to figure out the direction we can move in to provide greater transparency. And I think it would be very helpful. Thank you, Mr. Chairman.

Senator LEVIN. Thank you. I think each of you has said that the potential tax savings are not a factor in terms of the number of options that you would grant. Is that correct? I think each of you said that is not a factor.

Mr. CHALSTY. Yes.

Mr. TAUSCHER. Yes.

Mr. BOLLENBACH. Yes.

Senator LEVIN. Would you then have no objection if the tax rules were changed so that the tax deduction were the same as the book value?

Mr. BOLLENBACH. Well, for us we do not really have an opinion on that, and——

Senator LEVIN. So you would not object if the law were changed?

Mr. BOLLENBACH. No. We really would simply follow the law.

Senator LEVIN. But you would not take a position as to whether or not the law should be changed?

Mr. BOLLENBACH. No. I just truly think that is what the government does, is it sets these policies, particularly in the area of tax, and companies follow the law.

Senator LEVIN. Well, I know that you will follow it, but you would not have any position or objection to our changing the law to put in sync the book value and the tax return value?

Mr. BOLLENBACH. As a company, no.

Senator LEVIN. Mr. Chalsty.

Mr. CHALSTY. Chairman, I think we would have no objection either. We would follow the law. But I am curious as to exactly how you would do that. Are you saying that the companies would pay tax—would have to declare it and would not get the tax advantage while the recipient would still pay taxes?

Senator LEVIN. Sure.

Mr. CHALSTY. Now, it seems to me there is double counting there.

Senator LEVIN. But in terms of the taxing of the corporation, putting aside tax policy, you would not object from a corporate point of view?

Mr. CHALSTY. I understand the effect on the corporation, but on tax as a whole, it seems to me with the individual paying taxes on the award that is given and a company not getting a tax write-off, it seems to me that in the total package, there is double counting of taxes.

Senator LEVIN. I would disagree with you because the person who is selling his stock, buying and selling his stock, is getting that money from a different source, not from the company. So I would disagree with you on that. But in terms of your company's position, you would not object if the tax law were changed so that your tax deduction was the same as you showed on the books?

Mr. CHALSTY. I can only state again the company would follow the laws as written.

Senator LEVIN. I know, but in terms of lobbying Congress, if we were looking at that, would your company take a position for or against that change?

Mr. CHALSTY. Chairman Levin, I cannot speak for the company as a whole.

Senator LEVIN. Fair enough. Mr. Tauscher, do you have any objection if the law were changed to put in sync the value on the books with the tax deduction amount?

Mr. TAUSCHER. I think I would echo something I heard Senator Coleman say. I would want to make sure that there had been a fairly comprehensive look at the way the numbers really work in matching book expense to tax expense. Generally speaking, I think matching book and tax expense is a good thing. So I am not personally opposed to it—we would certainly follow whatever rules were asked, as the other two gentlemen said.

But I do think, as I said in some of my comments, it is very important to work with some of the data here because I am not sure that when you work with the data comprehensively, look at options not expensed, etc., it will turn out in quite the same way that the macro numbers that we are talking about here today imply.

Senator LEVIN. Well, I think that may be—we do not know what the macro numbers will turn out to be because we do not have the finished product yet from the IRS. We got part of it and we are very grateful for it, but it surely suggests something very strongly, which is that there is not only a gap between the book value for stock options that is taken at the time of the grant, but there is an overall significant gap—we do not know precisely how much—between that amount and the amount that is shown on tax returns by corporations. And my question is whether or not all of you who seem to say, well, this is not a factor in your compensation, which is—I take your testimony and there is no basis to disagree with you. I am not on a compensation committee. But I would think that any corporation would consider the possibility that if it grants a whole bunch of stock options and hoping its profits go up, by God, we are going to get a huge tax deduction as well. Our executives are going to do very well if our stock price goes up—that is the intent—and we get a big tax deduction as a result. Wow. How many times does that happen?

I will take your word for it. It is not a factor that goes in your mind, but I think the opposite side of that is what you testified to, Mr. Bollenbach. You just would not mind if we changed the law to make sure that the tax deduction is no different from the book amount. And I think that follows logically, and, Mr. Chalsty, your point is perfectly appropriate, that the person receiving all the money when he sells his stock pays taxes which are larger than the corporation got as a tax deduction. I would disagree with your conclusion, but it is a fair question. And, Mr. Tauscher, your point is certainly fair that you have to look at the overall picture, which we do not quite have. We do not know, for instance, how many corporations would then get a tax deduction for options which are never exercised because the value goes down. We know there are some of those, by the way. We do not know the amount. But given what has gone on at least recently, we would know and believe that it would be a significant amount. There would be a significant gap which would remain, perhaps not as big percentage-wise because of the reasons Senator Coleman gave. Some stock value obviously goes down and options are not exercised at the end. But, nonetheless, the company got a deduction up front based on Black-Scholes or whatever, so that is a legitimate point as well.

But the key point, which I hope Congress will look into, is this gap, and this is a group—we do not know if it is exactly that big or this big until the IRS finishes with all of its data. But when it does finish with its data, we will have an idea as to whether it is that big or this big. But it is there, and it represents both a loss to the Treasury, but also it represents a fueling of this gap between executive pay and the average worker, which has gone up now to an amount that no one believed it could ever reach.

You have all been very helpful. You have been forthright. We are grateful to you. We are grateful to your companies. We are glad you are profitable. And we appreciate your testimony and your being here today. As I pointed out—and I think everybody appreciates that this is a case where what is being done is legal. We are not looking into something which is illegal. And we particularly appreciate people showing up with a risk that it will be misunderstood, that what we are doing here would be misunderstood. We hope it will not be misunderstood. We are looking at a current tax law which has a bizarre feature in it which we think needs. I do not want to speak for any other Senator, but which I think needs to be changed.

Senator Coleman, do you want to add anything?

Senator COLEMAN. Yes, just very briefly. First of all, I want to make clear, Mr. Chairman, that I am not sure in the end we will be in the exact same place on what we do legislatively, but I think this issue has to be looked at. I applaud your putting this hearing together. There is a lot of concern out there in my State about this issue, and so I think we have got to deal with it.

Just very quickly, Financial Accounting Standard 123R is just in effect. Has that at all changed—are you changing your view of using stock options? Can you look into the future a little bit for me and talk to me about the use of stock options as compensation pre-123R versus post FAS 123R? Mr. Tauscher.

Mr. TAUSCHER. Well, I can only tell you that we are seeing data from various research firms that are being served up as a part of our practice with the Compensation Committee that says stock options have fallen now as amount issued by almost 30 percent. So given we are following market, that is a guideline that we are trying to do to retain executives. There is no question it has had an effect we have not seen yet, and given the timing of these options issued being previously granted years ago and the new FAS 123 effect just really starting, I think we are going to have some changes in these numbers as we go forward given the data we are seeing so far.

Senator COLEMAN. Mr. Chalsty.

Mr. CHALSTY. We are having a change in the allocation of stock options, but the change is really because of the dilution effect of stock options. We looked at it, and we have felt that the stock options are providing significant dilution to the number of shares. So they are being changed for performance-related stock, and that has the effect of not increasing the dilution, but it also has the effect of putting essentially all of the management's compensation at risk for performance, which we think has been very good.

Senator COLEMAN. Can you give me a sense of the scope of the change in terms of use of options?

Mr. CHALSTY. Well, options have been reduced. In fact, options as such have been eliminated. The company awards SARs, stock appreciation rights which have essentially the same impact. But there are these performance-related awards which are—if the company meets certain criteria going forward, then the management will receive these awards.

Senator COLEMAN. Mr. Bollenbach.

Mr. BOLLENBACH. You know, I am so new to the company that I really cannot answer that for you today, but I would be happy to have it investigated and respond to your counsel or to you directly

Senator COLEMAN. Great. Last, I would just comment again regarding my point about transparency. The SEC has rules about executive pay disclosure. I would urge all you gentlemen and others who are listening to look at that disclosure and work to make it simpler and make it clearer so your shareholders understand what you are paying your executives. I think there is concern about confidence, and those things that can be done to make disclosures digestible for the average investor, I think it would be very helpful and would be very worthwhile.

Thank you, Mr. Chairman.

Senator LEVIN. Thank you, Senator Coleman. And, again, Mr. Chalsty, thank you for raising an issue which is an important aspect of the stock option issue, which is the dilution issue, the average stockholder, by the large number of options when they are granted, that is an important issue. It is important to stockholders. It is important to us. It is not the focus of this Subcommittee, but it is something that we should have mentioned. And I am glad that you raised it.

Thank you all and you are excused.

Let me now welcome our second panel of witnesses this morning: Kevin Brown, the Acting Commissioner for the IRS, and John White, the Director of the Division of Corporation Finance at the Securities and Exchange Commission.

Pursuant to Rule 6, as I have mentioned, all witnesses who testify before this Subcommittee are required to be sworn, and I would then ask both of you to stand and raise your right hand.

Do you swear that the testimony you will give before this Subcommittee will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. BROWN. I do.

Mr. WHITE. I do.

Senator LEVIN. Mr. Brown, let us call on you first, then followed by Mr. White. Thank you for being here.

TESTIMONY OF KEVIN M. BROWN,[1] ACTING COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. BROWN. Good morning, Chairman Levin and, Ranking Member Coleman. I am pleased to appear before you this morning to discuss executive stock options and the book-tax differences between financial statements and tax returns filed by companies. Former Commissioner Everson met with this Subcommittee several times and enjoyed a positive relationship. I hope that we can continue that relationship, and I truly appreciate the important work that this Subcommittee and its staff have performed on behalf of tax law enforcement.

Let me begin with the difference between taxable income and book income, the income companies report under Financial Accounting Standards. The goal of tax administration is to measure income and deductions in accordance with the provisions that Congress establishes in the Internal Revenue Code. The goal of financial reporting is to provide data that are comparable between companies according to applicable accounting standards. Where tax law and accounting standards diverge, companies sometimes attempt to show the smallest possible tax profit and the largest possible book profit.

A divergence between tax and book income and deductions is reflected in the so-called book-tax difference for stock options. This book-tax difference reflects differences between the tax and ac-

[1] The prepared statement of Mr. Brown appears in the Appendix on page 72.

counting regimes. Absent additional evidence, a book-tax difference does not itself indicate noncompliance with our tax laws.

Let me offer a few words about administration of our tax laws regarding stock options.

First, the provisions of the code with respect to stock options, with several notable exceptions I will mention shortly, have generally not proven difficult for large corporations to comply with if they have the requisite governance and appropriate recordkeeping. This is true for both qualified and non-qualified stock option plans.

Second, the IRS is generally unable to identify most stock option issues until a tax return is filed and an examination started. For executive stock options granted under non-qualified plans, these would be returns for the years in which the stock options were exercised, not granted, generally 1 to 10 years after the date of grant. As a result, stock option problems are often identified by others first—the media, shareholders, stock analysts, and the Securities and Exchange Commission. This was the case most recently with backdated stock options.

Third, the IRS is not responsible for the examination of corporate governance with respect to executive stock options. Our role is limited to enforcement of those provisions that address how corporations and executives must treat stock options under the Internal Revenue Code, regardless of the motivation for or cause of the noncompliance. Where the Service identifies possible stock option or other executive compensation noncompliance, we attempt to deliver appropriate and focused examination and compliance responses.

For example, the IRS is undertaking the review of over 180 companies with confirmed or potential issues with respect to the backdating of stock options. We are well underway with our work in this area and will carefully scrutinize the tax returns and other information of companies implicated in this arena.

Notably, the Service also addressed the tax shelters that involved the improper transfer of stock options to family-controlled entities. A settlement initiative commenced in 2005 has resulted in the completion of 156 examinations and assessed taxes, penalties, and interest totaling over $211 million.

The Service appreciates the Subcommittee's keen interest in the subject of executive stock options. I look forward to answering your questions about the items I have touched upon as well as any other areas of interest to you. Thank you.

Senator LEVIN. Thank you, Mr. Brown. Mr. White.

TESTIMONY OF JOHN W. WHITE,[1] DIRECTOR, DIVISION OF CORPORATION FINANCE, SECURITIES AND EXCHANGE COMMISSION

Mr. WHITE. Chairman Levin, Senator Coleman, thank you for inviting me to testify before you today on behalf of the Securities and Exchange Commission on issues concerning stock option compensation.

Let me first review the Commission's role in this regard. The Commission is a neutral observer in matters relating to the form and amount of executive pay. As a disclosure agency, we focus on

[1] The prepared statement of Mr. White appears in the Appendix on page 79.

ensuring that a company's disclosure of its compensation decisions and practices is sufficiently transparent so that investors can properly assess the information and reach their own conclusion. It is not the role of the Commission to judge what constitutes the right level of compensation, correct types of compensation, or to place limits on what is paid.

Sir, as you know—and it has been discussed earlier today—the growth of equity-based compensation, particularly in the form of employee stock options, has been dramatic. In the use of option compensation, as it has increased, we have seen both abuses and the need for enhanced disclosure and transparency. And the Commission has been very active in that regard.

First, our Division of Enforcement is currently investigating more than 140 companies concerning possible fraudulent reporting of stock option grants and exercises. Including the actions that were announced last week, the Commission has charged four companies and 18 individuals (affiliated with nine different companies) with improper stock option grant practices. Fortunately, future opportunities for these kinds of abusive practices have been reduced considerably as a result of Sarbanes-Oxley, accounting changes, and a number of Commission initiatives. I would like to outline three of those initiatives.

The first is in 2002, following the passage of Sarbanes-Oxley, the Commission adopted rules requiring that officers and directors publicly report the grants of options 2 business days after the date of grant instead of after year-end, making backdating considerably more difficult.

Second, in 2004, of course, the Financial Accounting Standards Board issued FAS 123R, requiring, in effect, employee options to be expensed commencing in 2006.

And, third, in 2006, the Commission substantially revised its executive compensation disclosure rules effective for the current 2007 proxy season, including many new disclosures relating to options. For the first time, the dollar amount of compensation attributable to options must be disclosed. This is the same amount that is expensed under FAS 123R. This amount must be included as part of the employee's total compensation in the disclosure. Separately, and in addition, the full grant date fair value of option awards must also be disclosed.

So those are the principal changes that have been made. I would like to take the remainder of my time to briefly describe how FAS 123R changed option accounting and to contrast that with the tax requirements that Commissioner Brown has described.

Dating back to 1972, under APB Opinion 25, no compensation expense was recorded for the typical employee stock option grant if the option was granted "at the money," which is what most companies did.

In 1995, FASB changed the rules and issued FAS 123, which permitted companies to elect either to expense options or, if they made certain footnote disclosures, to continue to follow APB Option 25 and record no expense. Most companies elected to make the footnote disclosure and continue to record no expense. That was in 1995.

In 2004, of course, the FASB issued FAS 123R, which eliminated that election that was available under FAS 123 and generally requires the expensing of options. Under this approach, compensation expense is based on the option's fair value at the date of grant and is recognized over the vesting period. Fair value is typically measured using an option pricing model such as Black-Scholes.

In contrast, as Commissioner Brown has described, for tax purposes for non-statutory stock options, when an employee exercises an option the company is permitted a deduction equal to the option's intrinsic value, and the employee recognizes ordinary income in the same amount. So that is contrasting the two sets of rules.

Just one final observation. I know your Subcommittee is looking at the new aggregate Schedule M–3 data for 2004, and FAS 123R did not become effective for most companies until 2006. So there is no surprise if there is a substantial book-tax difference for 2004. But starting in 2006, when all companies were required to follow FAS 123R, presumably that tax-book difference will be less. But I think it is very important to realize that even when FAS 123R is fully implemented, there will be significant company-to-company differences between the book expense and the tax deduction for a variety of factors. You have alluded to a number of them, but I at least was able to list down four of them, so let me just list the four and then I will be done.

First, the amount involved is calculated differently, fair value versus intrinsic value.

Second, the timing of the measurement of the amount is different (the grant date versus the exercise date). And, thus, if you have unanticipated movements in stock price, either up or down, you will have no impact on the book expense but a very significant impact on the tax deduction, as was mentioned on the previous panel.

Third, the period of recognition is different. It is either over the vesting period versus at the exercise date.

And, fourth—and I guess one that often is not mentioned—the event-triggering measurement and recognition is under the control of a different party. It is a company decision to grant versus an employee decision to exercise, for whatever the employee's circumstances are.

So, Mr. Chairman, that completes my opening remarks. I would be pleased to take any questions.

Senator LEVIN. Thank you, Mr. White.

Mr. Brown, first, let me thank you and thank the IRS for performing the data analysis which we requested on the stock option material that is in the new Schedule M–3. Your staff was helpful and cooperative. We appreciate that. Would you tell us about the Schedule M–3 data on the book-tax difference that you have put together for us?

Mr. BROWN. Well, roughly 31,000 companies filed Schedule M–3s; approximately 3,000 of them showed a book-tax difference. The net there was about $43 billion, and as you mentioned before, Mr. Chairman, a small number of companies contributed to a great deal of that. Roughly 250 companies comprised about 82 percent of the book-tax difference for stock options.

Senator LEVIN. Now, of the $43 billion which you indicate is the difference, the total book-tax difference for Schedule M–3 filers in 2004 with respect to stock options. Is that correct?

Mr. BROWN. That is correct, sir.

Senator LEVIN. All right. Of the 250 companies which you say represented 82 percent of that $43 billion gap, how many of the 250 companies represented over half? Do you have that offhand? In other words, our figures are that the top 100 companies represented 56 percent of the gap. Is that something that your figures also show?

Mr. BROWN. Yes, that is correct.

Senator LEVIN. All right. And the top 50 companies represented 42 percent of the gap. Is that what your figures show?

Mr. BROWN. Yes, sir.

Senator LEVIN. Were you surprised to see that 250 companies were responsible for 82 percent of the total?

Mr. BROWN. I do not know if "surprised" would be the right word. It certainly was a number that piqued my curiosity, and when you look at this, part of it is explained by the fact that the data is not complete yet, that this requirement is just coming online, as Mr. White mentioned. I would actually like to look at future years' numbers before I draw a conclusion.

Senator LEVIN. Does the $43 billion in a single year represent a significant differential?

Mr. BROWN. It is a lot of money, yes, sir.

Senator LEVIN. Even at the IRS.

Mr. BROWN. Even at the IRS. [Laughter.]

Senator LEVIN. Now, there are differences, obviously, which we have been discussing this morning, between the financial accounting and the tax reporting rules. Have your two agencies had any discussions either in the context of stock options or on a much broader level of the possibility of having consistent reporting of corporate transactions for book and tax? Have you had discussions about that issue?

Mr. BROWN. I did not before yesterday. I believe our staffs have had some discussions about this.

Mr. WHITE. I am not aware of any discussions other than the ones we have had preparing for this.

Senator LEVIN. Do you have any conclusions or opinions on the subject, whether there ought to be consistent reporting? We will start with you, Mr. Brown.

Mr. BROWN. I do not have an opinion on that. Obviously, we like both the symmetry and the precision in the current system. It is relatively straightforward. It is easy to administer. We like that as tax administrators.

Senator LEVIN. Is the amount shown on the books now after FASB's rule precise?

Mr. BROWN. I am not an expert in Black-Scholes valuation.

Senator LEVIN. Mr. White, is the amount that is shown on the books a precise amount now? In other words, once it is on the books, is it a precise amount?

Mr. WHITE. Once the amount is determined at the date of grant, it remains fixed.

Senator LEVIN. Would you say "fixed" is the same as "precise"?

Mr. WHITE. Yes.

Senator LEVIN. All right. So that once the method is utilized and the dollar figure is determined, it is a precise figure and it is on the books. Is that correct?

Mr. WHITE. That is correct.

Senator LEVIN. And you are interested in precision, aren't you, Mr. Brown?

Mr. BROWN. Yes, sir.

Senator LEVIN. Is that a precise figure, then?

Mr. BROWN. Obviously, our agents would have to educate themselves about Black-Scholes and the other methods for——

Senator LEVIN. No, not how it is reached, but is the figure that is on the books a precise figure?

Mr. BROWN. I will take his word for it that it is precise, yes.

Mr. WHITE. I might clarify that in some cases companies follow the liability method and you could have a variable number.

Senator LEVIN. Right. I understand. But whichever method is used, after the method is utilized, there is a specific figure that is put on the company's books. Is that correct?

Mr. WHITE. That is correct, sir.

Senator LEVIN. OK. And that would be precise from your definition of "precise," Mr. Brown?

Mr. BROWN. Yes, sir.

Senator LEVIN. Are stock options the only kind of compensation that you are aware of, Mr. Brown, where the corporation gets to deduct more than the expense shown on its books?

Mr. BROWN. Yes.

Senator LEVIN. In those cases where the price of the stock that is sold after the exercise of the option is greater than the price that is shown on the books, that is what we are referring to.

Mr. BROWN. They are the only ones that I am aware of.

Senator LEVIN. And we do not know whether that represents 60, 70, 80, or 90 percent. It would depend on the stock market and a lot of other things. Is that correct?

Mr. BROWN. Yes.

Senator LEVIN. But in your analysis that you have done of that 1 year, that seemed to represent a significant percentage of the gaps.

Mr. BROWN. Yes. It is the third largest number behind depreciation and reportable transactions.

Senator LEVIN. All right. Senator Coleman.

Senator COLEMAN. One of the questions that comes up is the valuation models with Black-Scholes or binomial lattice models, kind of the two used most often?

Mr. WHITE. Yes, they are.

Senator COLEMAN. Is your sense, Mr. White, that they provide an accurate—we have looked at, obviously, some of the figures provided by the Chairman, and clearly there is a question whether these are accurate means of estimating option values. Have you assessed the accuracy of these SEC-approved valuation models? Are there other options that are out there?

Mr. WHITE. "SEC approved" is probably not exactly the terminology I would use. FAS 123R was a rule that came about through the deliberative process that occurs at the FASB, which is an independent standard setter which is overseen by the SEC. Obviously, FASB went about this process over a substantial period of time and came to the conclusion that using a model is an acceptable way of doing this. Black-Scholes is the model that has emerged as the most common one.

Senator COLEMAN. Companies have flexibility, as I understand it, in choosing the model. They do not have to use Black-Scholes. They can use something else. Is there some value, some benefit, in requiring all companies to use the same valuation model? Or is there some concern that standardization would result in less disclosure? Why the flexibility? And is there an issue with standardization?

Mr. WHITE. Again, the rules were set by FASB here, and given in this world where I think we are focused on principles-based accounting, their decision to provide some latitude in terms of the method would seem to make sense.

What FASB said was that the best choice would be a model that looked at a market-based instrument that was similar or the same as the options. But if that is not available, then you should look at a model that met—there were a number of criteria that are listed in the rules that the model needs to meet, and Black-Scholes and the lattice model in most circumstances meet those criteria. But, I mean, certainly the rule gives you some flexibility to choose the method.

Senator COLEMAN. One of the things that we do not have in front of us, because we do not have the data yet, is the impact of this gap, tax-book gap, post-FAS 123R. Do we have any sense as to whether most publicly traded companies report similar gaps once FAS 123R is in effect? Do we have any data as to—and, again, it is early, but can you give us a sense, perhaps Mr. Brown, or even Mr. White, of where we are going with post-use of FAS 123R?

Mr. BROWN. We do not have any data to offer, anything more than just a guess.

Senator COLEMAN. As I listened to the data from the Chairman, if I am correct, 82 percent of the gap comes from 250 companies. I think you indicated that the $43 billion results from a survey of 3,200 companies, so there are about 3,000 companies that have—82 percent from 250, so 18 percent results from the rest, the 3,000 companies. My sense is that the book-tax gap is not as large for a large number of companies that issue stock options even before FAS 123R. And, again, I am trying to get a sense of where we are going to be after FAS 123R.

Mr. BROWN. I think one of the problems was the rule was not—it is just coming online, so it is difficult to predict.

Senator COLEMAN. What do you do with the issue—one of the concerns that I—again, look back, and my sense is that the changes that we made in 1993, in Section 162(m) which capped companies' deductions for salaries paid to top executives, caused companies to switch from cash to stock option compensation. They are giving compensation—the value of the company is not diminished in terms of an SEC perspective, though there are these obligations out there. And yet those are real obligations. In the end, when they capitalize on those obligations, this huge benefit to the individual, and also benefit to the company by way of the deduction. So that is the world that the Congress created with Setion 162(m).

My concern is as we go—if the solution is one in which we kind of cap—equalize tax value and book value early on, for instance, in the scenario if the market is not rising and, in effect, we give deductions up front based on what we project equalizing tax and book value, and if options are not exercised or if there is a diminution of stock price, what happens in terms of monies coming to the IRS?

Mr. BROWN. Well, you would have the deductions claimed in the years during the vesting period, and you would not have income recognized by the employee on the back-end if the stock was not in the money.

Senator COLEMAN. So you would have shadow deductions. You would have deductions taken with the company, in effect, not giving anything to the—they would get the value of the deduction but, in fact, not submitting anything to the IRS.

Mr. BROWN. You would lose the symmetry there.

Senator COLEMAN. So how do you account for that? How do you find a system that does not have that problem?

Mr. BROWN. Well, the current system does not have that problem because you match exactly the income with the deductions.

Senator COLEMAN. Again, I keep wanting to get back to disclosure, disclosure, disclosure, disclosure.

Last question, Mr. White. The SEC has provided new proxy disclosures. How satisfied are you with them? Could we push the envelope on proxy disclosures?

Mr. WHITE. Well, the new disclosures are just coming in, in the month of—in April, May, and June, so in terms of a thorough analysis of them, we are just starting that process, actually in my division. But as a general matter, I think we are optimistic and pleased.

One of the concerns that has been expressed is one that you have alluded to several times this morning of how well people have done in following plain English and in clarity in writing the new disclosures. I know Chairman Cox has commented on that as well, that is probably an area that is going to require a little bit of work, and is one of the things we are looking at.

But I think as a general matter, just as a preliminary look, we are pretty happy with what has come in.

Senator COLEMAN. We look forward to working with you on that issue. It is important. We have seen it with our review of credit card companies and disclosures to individuals there, and, again, concern to the average shareholder. I think they are at a substantial disadvantage today with the lack of easy access to information, so hopefully this will be a step in the right direction.

Thank you, Mr. Chairman.

Senator LEVIN. Thank you. Mr. Brown, under the current FASB system, when options are granted to employees, the companies take an expense now. Is that correct?

Mr. BROWN. That is correct.

Senator LEVIN. And that is true whether or not the employee gets any benefit from it at all. For instance, if the stock becomes worthless, the employee would get no benefit whatsoever?

Mr. BROWN. That is correct.

Senator LEVIN. Do you support the FASB rule?

Mr. BROWN. It is sort of out of my province.

Senator LEVIN. Mr. White, do you support the FASB rule? Does SEC support the FASB rule?

Mr. WHITE. The SEC believes that the FASB has gone through the appropriate deliberative process to pass the rule, and we have reviewed that as they have gone along, and through our oversight role of the FASB in this regard, we are satisfied.

Senator LEVIN. OK. So assuming that it is a satisfactory rule now, Mr. Brown, it does result in the company being able currently to take an expense. Is that not correct?

Mr. BROWN. That is correct.

Senator LEVIN. On its books.

Mr. BROWN. That is correct.

Senator LEVIN. Even though there may not be any benefit whatsoever to the taxpayer.

Mr. BROWN. That is correct. To the employee, the employee tax——

Senator LEVIN. Potential tax——

Mr. BROWN. That is right.

Senator LEVIN. Employee taxpayer. Do you have a problem with that?

Mr. BROWN. My area is making sure that the deductions and the income are properly reported, so what happens with regard to the books is not an area the IRS focuses on.

Senator LEVIN. You are going to receive, I believe, the 2005 data sometime later this year. Is that correct, Mr. Brown?

Mr. BROWN. That is correct.

Senator LEVIN. And then as soon as that information becomes available, will you make the same kind of analysis of that data as you did for the 2004 data for this Subcommittee?

Mr. BROWN. Yes, sir.

Senator LEVIN. And let us know what the results are?

Mr. BROWN. Yes.

Senator LEVIN. Then would you at that time also include an estimate of what the revenue effect would have been for 2005 if the stock option tax deduction had matched the stock option book expense? Are you going to be able to do that for us?

Mr. BROWN. Yes, sir. We will give it our best try.

Senator LEVIN. OK. I know Senator Coleman has a number of other things he is trying to cover this morning, so he is covering a lot of territory.

Thank you both very much for your testimony and for your cooperation.

We will call our third panel. Let us now welcome our final panel of witnesses for this morning's hearing: Lynn Turner, former SEC Chief Accountant; Professor Desai, the Arthur Rock Center for Entrepreneurship Associate Professor at Harvard University's Graduate School of Business Administration; and Jeff Mahoney, who is General Counsel of the Council of Institutional Investors.

We welcome you to this Subcommittee. In the case of Mr. Turner, we are going to welcome you back to the Subcommittee. You testified before this Subcommittee in 2002 on the role of financial institutions in Enron's collapse, and it is still very much an issue in the news and the courts. We appreciated your testimony then.

Mr. TURNER. Thank you, Senator.

Senator LEVIN. Under Rule 6, again, all witnesses who testify are required to be sworn. We would ask that each of you stand and raise your right hand.

Do you swear that the testimony you will give before this Subcommittee today will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. TURNER. I do.

Mr. DESAI. I do.

Mr. MAHONEY. I do.

Senator LEVIN. You were here for the explanation of the timing system, I believe, and we will have you, Mr. Turner, go first, followed by Professor Desai, followed by Mr. Mahoney. And, again, we appreciate your appearance here today.

TESTIMONY OF LYNN E. TURNER,[1] FORMER SECURITIES AND EXCHANGE COMMISSION CHIEF ACCOUNTANT, BROOMFIELD, COLORADO

Mr. TURNER. Thank you, Chairman Levin, as well as Ranking Member Coleman, for inviting me here today. I think this issue of stock options is certainly an important issue, so I commend both of you for holding this hearing in this Subcommittee.

My views, I am going to try to summarize in light of the time we have here, so I would ask that the written testimony be entered into the record.

Senator LEVIN. It will be made part of the record, as will all the testimony.

Mr. TURNER. My views are also going to be fashioned based on the fact that I currently serve as a corporate board member, also a member of trustees of a mutual fund who invest in these companies, having served in my prior life as a chief financial officer and SEC Chief Accountant as well as managing director of an investment proxy and financial research firm. And certainly, as you have mentioned, the issue of executive compensation has been one that has attracted a lot of interest in the past, regardless of the perspective from which one observes it. However, in the past decade, many of the newspapers on the front pages have heralded the excesses in compensation at more than just a few public companies. Certainly these excesses are due in no small part to abuses in the use of stock options. Recent decisions of the Delaware courts have highlighted the activities of illegal backdating and spring-loading of options and the lack of transparency surrounding that process, as well as the lack of fiduciary fulfillment of their obligations on the part of directors. And research has suggested that during the period from 1996 to December 2005, over 13 percent of all stock option grants were done inappropriately and manipulated in some fashion or form.

But backdating has not been the only option. We have seen repricing of stock options become all too common in a situation where, in essence, the holders of those options were given a mul-

[1] The prepared statement of Mr. Turner appears in the Appendix on page 90.

ligan when the prices went down that obviously the average investor—the 90 million Americans investing in these companies were not given the same economic benefit.

We have seen over 1,000 occasions where public companies have accelerated the date on which options were considered vested such that employees did not even have to work the entire time they were supposed to work for those options. And in some cases, that resulted in great intrinsic value going to the people who held those options.

We have heard a lot of discussion this morning about the new FASB accounting pronouncement, FAS 123R, and yet no sooner was the ink drying on that document than people were trying to get around how the calculation was made. And it brought on some practices, including manipulation of key assumptions. It appears that they are once again managing the numbers that are reported to investors as opposed to really trying to manage the business.

On this point, I would just like to say, Chairman Levin, you deserve tremendous kudos, because when the fight was on about whether or not to really show the true economic value of these options and the financial statements, you yourself were a key supporter in improving the transparency for investors in that regard. And as an investor, I would just like to thank you and the other Members of Congress who helped get us where we needed to be on that.

But I guess my biggest concern, when you look at the abuses and you look at things on options, is that there has been now more than one—a number of economic studies by academics that indicate that there is a direct linkage between the use of stock options and heightened fraud in public companies. I do think that options have become like an addictive drug for executives because of the tremendous upsides that are there. I am certainly not the only one. Former Federal Reserve Chairman Paul Volcker has also raised some of the same type of concerns.

In light of that, I think we ought to really consider what steps can be taken to help foster good governance and management and lawful behavior and greater transparency. And I think it can.

As a former business executive and partner in a major international accounting firm, I have seen up front how income tax laws and regulations do affect business decisions, sometimes in a negative fashion. It should be no surprise that my experience has shown that management often tries to maximize both the amount and timing of expense deductions for income tax purposes while minimizing them for purposes of financial reporting to investors. It is simply a matter of minimizing net income for tax purposes and maximizing net income reported to investors.

Income tax deductions can have a very significant impact on the cash flow of any company, and so it behooves management to maximize them. And, of course, the analysis of any stock option program is going to include the impact of the cost to the company on a net basis, after factoring in any benefits from income tax deductions. As such, these tax implications also provide a strong incentive for management to see how close to the line they can get when preparing their income tax returns and encourage taking of aggressive income tax positions. This is especially true for public companies. And as we have seen with recent corporate scandals, some seem blinded to when they are getting close to the line as opposed to going over it.

As a result, I would strongly recommend the creation of tax legislation and regulations that would foster a consistent calculation of the amount of the deduction for the fair value of options for both financial reporting and income tax purposes. I firmly believe there is an economic cost to the issuance of options. That cost should not vary simply because it is reported to the Internal Revenue Service on a Form 1120 as opposed to investors on a Form 10–K.

Unfortunately, current income tax regulations have created incentives that have led to the abuses noted earlier and should be considered for appropriate modifications. In that regard, I echo some of the comments of Ranking Member Coleman with respect to Section 162(m).

Legislation that did result in symmetry would create a very positive incentive for companies to stop manipulating and minimizing the amount of expense they report to investors. Rather, it would result in a more balanced approach in which both transparency for investors and income tax considerations would be balanced. In essence, the desire to report higher earnings to investors by manipulating the amount of stock option expense downward would be appropriately balanced by the desire to maximize income tax deductions, and in doing so maximizing cash flow.

Legislation giving shareholders an advisory vote on compensation, such as that recently passed in the House, should also be adopted. Many foreign countries such as the United Kingdom, the Netherlands, and Australia have already adopted such legislation, and it is an important part of their regulatory scheme, and I think would be important to the competitiveness of our U.S. capital markets.

Finally, I believe active and appropriate oversight by the SEC of reporting of executive compensation is needed as well. Actions taken to date indicate that many responsible for the option backdating scandal will either never be known or will avoid accountability for behavior outside the law. We have over 260 companies announce that they are investigating for option backdating. Academic research indicates that there are hundreds more that have never come out and fully disclosed it. As we heard from the SEC earlier this morning, despite several hundred cases, we have only had four cases brought against companies to date, and only 18 executives, which is basically a drop in the bucket compared to what is happening. That is hardly what I would call an effective law enforcement system. Likewise, the use of models to fair value options that are intended simply to minimize and manipulate the value of stock options should be more closely examined by the SEC and prohibited.

That concludes my remarks, and I would be happy to take any questions.

Senator LEVIN. Thank you, Mr. Turner. Professor Desai.

TESTIMONY OF MIHIR A. DESAI,[1] ARTHUR M. ROCK CENTER FOR ENTREPRENEURSHIP ASSOCIATE PROFESSOR, HARVARD UNIVERSITY, GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, BOSTON, MASSACHUSETTS

Mr. DESAI. Chairman Levin and Senator Coleman, it is a pleasure to appear before you today. I am an Associate Professor of Finance at Harvard Business School, where I conduct research on corporate finance and public finance and their intersection, specifically about how taxation influences firm behavior.

Independently, the topics of financial accounting, tax accounting, and stock options are extremely confusing. Taken together, they can be overwhelming and, frankly, mind-numbing. While my written comments below are much more nuanced, I thought I would begin with a thought experiment that I have found helpful for simplifying the relevant issues and then summarize five conclusions that are detailed in my written comments.

Imagine if you were allowed to represent your income to the IRS on your 1040 in one way and on your credit application to your mortgage lender in another way. In a moment of weakness, you might account for your income favorably to your prospective lender and not so favorably to the IRS. You might find yourself coming up with all kinds of curious rationalizations for why something is an expense for the tax authorities but not an expense to the lender.

You do not have this opportunity and for good reason. Your lender can rely on the 1040 they review when deciding whether you are creditworthy because you would not overly inflate your earnings given your desire to minimize taxes. Similarly, tax authorities can rely on the use of the 1040 for other purposes to limit the degree of income understatement given your need for capital. The uniformity with which you are forced to characterize your economic situation provides a natural limit on opportunistic behavior.

While individuals are not faced with this perplexing choice of how to characterize their income depending on the audience, corporations find themselves in this curious situation. A dual reporting system is standard in corporate America and, judging from recent analysis, the system can give rise to opportunistic behavior. As we have heard today, a significant cost for corporations—the cost associated with compensating key employees with stock options—was until recently treated as an expense for tax purposes but not for financial accounting purposes. This can be viewed as the most advantageous way to treat an expense—reducing the firm's tax liability while not detracting at all from its financial bottom line.

Recent changes in financial accounting have changed this asymmetry so that there is now an expense associated with stock options, but a considerable difference still exists with tax rules. Specifically, the amount and timing of the deduction are distinctive. Grant and exercise values, as well as their timing, will differ significantly. Historically, the distinctive treatment of stock options has contributed significantly to the overall difference between financial and tax accounting reports, as shown in my work and recent work based on the Schedule M–3 reconciliation.

[1] The prepared statement of Mr. Desai with attachments appears in the Appendix on page 95.

Does this situation make sense? In order to consider this question, my written statement reviews the nature of the dual reporting system in the United States, the debate over changing this system to one where conformity would be more common, the international experience with increased conformity, evidence on the behavioral consequences of stock options, and international variation on the tax treatment of stock options. Several conclusions emerge.

First, as suggested by the example above and further elaborated on below, the dual reporting system can enable opportunistic behavior by managers at the expense of both investors and tax authorities. This insight, from an emerging body of work labeled the "corporate governance view of taxation," suggests that tax authorities can be meaningful monitors that complement the activities of shareholders concerned with opportunistic insiders. Under the current dual reporting system, it is impossible for investors to tell what firms pay in taxes. A major part of a cost structure of a firm, its tax payments, are completely unavailable to an investor, and this clouds what a firm's true economic performance is. The evolution of the two parallel universes of financial and accounting reporting systems appears to be a historical accident rather than a manifestation of two competing views of what profits should be. Aligning tax definitions with financial accounting standards can have payoffs to investors and tax authorities, can lower compliance costs of the corporate tax, and potentially allow for a lower corporate tax rate on a wider base. Concerns over greater alignment between tax and financial accounting are important, but many of these concerns are overstated, as I discuss below.

Second, changing financial accounting standards has stimulated debate worldwide on the virtues of greater conformity. Many countries, including notably the United Kingdom, have shifted toward greater alignment of tax and accounting reports with little apparent disruption. More broadly, tax authorities in many countries in the European Union explicitly reference financial accounting treatments in several parts of the tax treatment of corporations. Indeed, the European Union is contemplating yet a more aggressive alignment between tax and accounting rules. The relative segregation of financial accounting and tax treatment of corporate income appears to make the United States somewhat anomalous by international standards. By itself, this international experience is informative but hardly decisive as the United States may choose quite different rules for good reasons. Nonetheless, it is enlightening to see that increased conformity can work and need not represent a doomsday outcome as some have suggested.

Third, stock options are a critical part of our economic system today. They are extremely valuable tools that have numerous benefits and several costs. Their use is influenced by their accounting treatment and by their tax treatment. Research is quite clear on this. As such, changing the accounting and tax treatments of stock options can be expected to change their use. Existing evidence, though scant, is consistent with the recent increased disclosure limiting the use of stock options but also with investors appreciating the disclosure and changing their valuations of firms accordingly.

Fourth, there exists considerable variation internationally on the tax treatment of stock options. In particular, some countries, such as Canada, do not allow any tax deduction for stock options while others take the deduction at the time of grant and others follow the United States and provide a deduction at the time of exercise. Again, this international experience is informative but hardly conclusive as the United States may choose quite different rules given that stock option compensation is much more central to compensation in the United States than elsewhere. Nonetheless, it is enlightening to realize that there are many different ways to solve this problem and that the current situation is not a natural solution.

Fifth, and finally, bringing the tax treatment of stock options into alignment with the recent changes to the accounting treatment has a number of virtues. First, it would make the tax treatment consistent with the accounting profession's well-reasoned analysis of when this deduction is appropriate and what the right amount of the deduction is. Second, as with other movements toward greater alignment, reducing the reporting distinction in how managers are paid can create greater accountability and reduce distortions to the form of managerial compensation. Third, there is limited reason to believe that the purported costs typically attributed to greater alignment between tax and financial accounting would be relevant in this setting. There are a number of nontrivial complications associated with such a change, particularly related to the matching principles and issues that came up previously. While these complications are nontrivial, they can be overcome readily if legal and political will exists.

In sum, this example of increased alignment between financial and tax accounting has much to recommend it and need not be viewed as a radical departure from global practice. It will still allow for the many benefits of incentive compensation to accrue to the U.S. economy without continuing the distortions associated with the current anomalous distinction between tax and accounting reports.

Thank you, Mr. Chairman, for the opportunity to share these views, and I look forward to answering any questions.

Senator LEVIN. Thank you, Professor Desai. Mr. Mahoney.

TESTIMONY OF JEFFREY P. MAHONEY,[1] GENERAL COUNSEL, COUNCIL OF INSTITUTIONAL INVESTORS, WASHINGTON, DC

Mr. MAHONEY. Chairman Levin, I am Jeff Mahoney, General Counsel of the Council of Institutional Investors. I am pleased to appear before you today on behalf of 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 generally long-term shareowners responsible for safeguarding assets used to fund the pension benefits of millions of participants and beneficiaries throughout the United States. Since the average council member invests approximately 75 percent of its entire pension portfolio in U.S. stocks and bonds, issues relating to U.S. 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.

[1] The prepared statement of Mr. Mahoney with attachments appears in the Appendix on page 124.

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. 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 approved a revision to the council's corporate governance policies that recommended 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 their policies relating to stock options, are applied to individual pay packages of those executives.

Second, the council has publicly raised concerns about the Securities and Exchange Commission's December 2006 amendments to the Commission's new proxy statement disclosure rules on executive compensation and related-party disclosures. Those amendments, we believe, 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 in those disclosures. As a result of the change, the summary compensation table, as now revised by the amendments, 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 would agree is not particularly useful information when assessing the performance of compensation committees. We, however, are pleased that the SEC staff has publicly acknowledged our concerns and other investor concerns that have been raised about 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, and we look forward to reviewing and commenting on the report.

Finally, we have been monitoring the implementation of the FASB's Statement 123R. That standard, which became effective last year for most companies, is important to investors because, as the Chairman knows, it closes a significant loophole in financial reporting. That loophole had a number of effects, one effect being that it encouraged 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, second, the loophole also had the effect of permitting companies to understate their compensation costs, thereby distorting their 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 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 that Zions Bancorporation 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 for its own options and they plan to market this product, to other public companies as well.

After consulting with leading valuation and accounting experts from around the country, 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 U.S. capital market system.

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

Senator LEVIN. Thank you, Mr. Mahoney.

This is an issue which was raised with the first panel, not exactly the focus of the hearing, but I think it is important that we get your comments on it. Given the millions of options that are being handed out to executives, does that have a negative effect on existing shareholders, other shareholders? Mr. Turner, what is the effect of the large number of stock options granted particularly to executives on the other shareholders? Does it water down their stock?

Mr. TURNER. Certainly, if you look over the years, the use of options has grown, especially since the mid-1980s, and that has resulted in a significant increase in the growth of overhang and dilution and potential dilution to existing shareholders. In fact, if you looked at reports that have been put out by rating agencies such as Fitch's, they have noted that it has actually become a significant drain on investor assets and that to avoid increasing dilution, many companies have had to go out and spend cash on fund share buybacks. And as a result, it has certainly had a significant impact, negative impact on cash. So the significant growth in the use of options has had a very real impact. I think it is why the Conference Board in part recommended and others have recommended—and I certainly think it is a good recommendation—that companies start to look at other vehicles such as restrictive stock, which I know has gotten increasing use in recent years.

Senator LEVIN. Thank you. Professor Desai.

Mr. DESAI. I think the major consequence for other shareholders is not quite so much the dilution issue as the behavioral response to the stock options, and by that I mean two things. One is, on the positive side, it makes them potentially more performance oriented. And on the negative side, it has been shown to, first, increase risk taking; second, it has been associated with more aggressive accounting treatments; and, third, it is questionable whether there is a way to have CEOs set their own pay in an arm's-length way.

So to me, the major consequences to the other shareholders are all the behavioral responses that the CEO undertakes, which can be potentially good and can in many cases be quite negative, and it has been shown to be negative.

Senator LEVIN. Thank you. Mr. Mahoney.

Mr. MAHONEY. The council agrees that the potential dilution represented by stock options is a direct cost to shareholders. As I pointed out in my testimony, we prefer that compensation be performance based, and prior to FAS 123R, many of the stock options granted were not performance based. And that is why we supported the expensing of stock options.

Senator LEVIN. The IRS has now released the data showing that overall in 2004, about 3,200 corporations claimed $43 billion more in stock option expenses on their tax returns than they reported to investors on their financial statements. Mr. Turner, does that number surprise you?

Mr. TURNER. No, not at all, especially given the accounting rules at the time. But I think that even when you get good data for 2005 and subsequent years after the implementation of FAS 123R, I suspect that you are still going to see that the deduction for tax purposes runs ahead of what it is for book purposes. Perhaps the best indication of that is if business and tax lobbyists obviously thought that they were going to get a bigger deduction for FAS 123R, I suppose they would be at your desk signing up to support you. And so far I have not seen anyone standing outside your door looking to support you on that, so I think that probably is a pretty good indication of which one is going to be the bigger deduction for them.

Senator LEVIN. Professor Desai.

Mr. DESAI. No, it does not. Those numbers jibe with numbers that myself and others produced prior to the Schedule M–3 reconciliation being available, so they do not surprise me. And I should mention nor does the concentration of that gaps amongst a relatively small set of firms surprise me. That, too, is something that has been in the data for a while and is clearly true.

Just by way of perspective, the reason that is so concentrated is because, in fact, market values of firms are highly concentrated. So I think those numbers make a lot of sense.

Senator LEVIN. Thank you. Mr. Mahoney.

Mr. MAHONEY. No, it does not surprise me. It is my understanding that financial reporting and tax reporting historically have had very different purposes. Where financial reporting attempts to reflect the underlying economic substance of an activity in the periods that that activity occurs, tax reporting has not always had economic substance as an underlying factor. I am not an expert on tax accounting, but certainly there are a number of areas of tax law where the underlying economic substance of the activity is not the basis for the tax treatment.

Senator LEVIN. Well, as far as we can tell, the only type of compensation where corporations are allowed to deduct from their tax as an expense that is larger than the expense on their books is stock options. Is that your understanding, too? Do any of you know of any other form of compensation where that is true?

Mr. TURNER. Senator, I heard you ask that question of the IRS Commissioner, and I think he confirmed that is true. Certainly, as I was thinking about that, I tried to think back to days when I was signing these income tax returns, and I think that was certainly consistent with what my understanding was.

Senator LEVIN. Professor Desai, do you know of any other example of this?

Mr. DESAI. No, I do not. I will say that there is a dizzying array of new financial contracts being awarded to management, and it is not clear to me that all of those—for all of those things this is true. So I do not quite know, but I think the IRS Commissioner——

Senator LEVIN. Do you know any, Mr. Mahoney?

Mr. MAHONEY. No, I do not.

Senator LEVIN. For each of you, looking at the new rule, FAS 123R, would you say that the—first of all, do you support the rule? Do you think it is a good rule? Mr. Turner.

Mr. TURNER. I think getting the expensing of stock options into the financial statements and really showing a true picture to investors was long overdue and a good rule. There are pieces of it that I would probably change, but overall I think it was a very good rule.

Senator LEVIN. Professor Desai.

Mr. DESAI. Agreed.

Senator LEVIN. Mr. Mahoney.

Mr. MAHONEY. We agree. It is consistent with our policies.

Senator LEVIN. All right. Now, under the current tax rule that we have, you can get a much larger tax deduction than your book value shows is the value of the—or the expense for the option that you granted. Does it make sense for companies that do very well, hand out a lot of stock options, when their stock price goes up, they get bigger tax deductions and lower taxes? Is that, from a tax policy, good, that incentive to give tax options, since they do well, if the company does well, result in a larger deduction, it means the more profitable the company, the larger the tax deduction rather than the larger the tax? Is that good tax policy, Mr. Turner?

Mr. TURNER. Well, I have for a long time been a believer that absent some real driving policy that Congress wants to get into, such as creating additional capital investment, which we do on depreciation and asset acquisitions, I have long been a believer that we should have symmetry and more economic substance to what goes into our tax rules. And in that regard, I have always been a supporter of getting more symmetry between the economic substance that is reported in financial reports and what goes into our income tax returns. I think the income tax returns should show more economic policy than what they are. And so to the degree that they differ, I do not think that is good tax policy. Therefore, I think it would be good to have symmetry in the executive compensation. I would also, quite frankly, have symmetry in other areas, such as for uncollectible accounts receivable and for inventories that have gone bad and are obsolete. There are differences there that I think also fall into the same categories, and I do not see a reason, a real good tax policy for having differences there as well.

So I am a fan of trying to keep it simple, if you will, make it more simple. I think most Americans would like to see the Tax Code greatly simplified, and I think this would be an opportunity to do that in a number of areas.

Senator LEVIN. OK, but including in terms of today's hearing, having the tax deduction be the same as the amount shown on the books?

Mr. TURNER. Absolutely.

Senator LEVIN. Professor Desai, do you have any comment?

Mr. DESAI. Yes, I would agree with what Mr. Turner said. I think greater alignment generally is a smart idea, and particularly in this context makes sense. I have two points on that.

First, typically tax policy tries to accelerate a deduction when times are bad, so the situation you are describing is unusual. And then the second point I would make——

Senator LEVIN. When you say "unusual," you also mean not desirable, particularly, or——

Mr. DESAI. Hard to rationalize, yes.

Senator LEVIN. OK.

Mr. DESAI. And then the second point would just be that in some sense it is a simple issue, which is when was this compensation for and how much was the compensation. And I have great faith in FASB and the ability of experts to come up with a good answer to that. And it seems like if we can piggyback off that answer in the Tax Code, that would seem to make sense.

Senator LEVIN. Mr. Mahoney.

Mr. MAHONEY. The council has not established any policies on taxation at all, but as a taxpayer myself and a small investor, I agree with my other two panelists that that is not good tax policy.

Senator LEVIN. Is this feature of stock options, is this particular feature that the company does well, that they then get a much bigger tax deduction in their income tax reports than they show on their books a driving force in the use of stock options, one, in your judgment? And, two, in the gap that exists, which seems to be growing, between executive pay and average worker pay, would you say that it is a driving force in both?

Mr. TURNER. I do not know. The way I think I would put it, Senator, is to say there are a number of factors that enter into the consideration of using options and the magnitude of the options that you are going to use. Certainly the opportunity for a company to go up in value, which any management team strives for, creates a real incentive to use options. And now I am speaking as a former executive and CFO—when you look at option plans along with anything else, you are trying to look at what is a reasonable compensation level for the people, especially vis-a-vis the peers. And I think that becomes first and foremost, but certainly the tax implications of the ability to use options is one of the factors that one would consider. Even at the board level it is considered, because in almost every proxy the board discusses and discloses Section 162(m) as well.

And certainly I would have to say the Section 162(m), as Ranking Member Coleman has noted, is a factor here that I think, quite frankly, Congress should also take a look at. I would view it as, in a way, a package situation. I think your move to get symmetry is superb and excellent and should be undertaken. I would undertake that with reconsideration of Section 162(m), and at the same time, though, I would also want to put in there the shareholder advisory vote that has been adopted in the House. I think if you could put a package like that together, that would be a marvelous tax package.

Senator LEVIN. We heard earlier this morning from the first panel that they do not look at the tax aspects of the options that they recommend or decide upon on compensation boards. Do you buy that?

Mr. TURNER. No, I do not buy that because—and, again, sitting on corporate boards, I think most corporate boards do sit down, at least in the compensation committee, and have a discussion about the implication of Section 162(m). And, in fact, often, where I have been the managing director of research and provide voting recommendations on proxies, one issue that often comes up for a vote is the issue of does the compensation package meet Section 162(m) requirements.

Senator LEVIN. But does this feature of stock options that it potentially has this huge tax deduction without showing it as an expense to the same extent on the books, is that a feature which would be in your mind as a member of the compensation committee?

Mr. TURNER. It certainly is, and I have chaired three audit committees now, and not only is it on my mind as a matter of stock compensation, and certainly much more in my mind since the option backdating scandal. Senator Grassley had a fine hearing here in the Finance Committee last September that got into that whole issue. And so I would be surprised if people said it does not enter into my consideration as the CFO or as a board member. I think I would be negligent if I had not considered the overall cost package. So I was somewhat surprised by that.

Again, that is often discussed and laid out in a proxy, which I would hope every corporate board member reads before they get filed. So to say "I did not even think about it," is somewhat surprising.

Senator LEVIN. Professor Desai.

Mr. DESAI. I would concur. On your first question, has it been an important driver of the growth of options, I think if firms do not factor in the tax consequences and boards do not think about that, then there is a question of whether they are pursuing their fiduciary responsibility. So I would think they would be, and, in general, I think people are pursuing their fiduciary responsibility. So I think that it does matter.

And then the second related point is there is evidence that tax departments inside corporations are becoming more active participants in financial decisionmaking, and they are becoming viewed as places where you can squeeze profits out of. And so it would be surprising if tax concerns were just not visible.

On your second question about whether this relates to the overall gap in income inequality, that is a much harder question. The available research on that suggests that the gap is surely due in part to this kind of pattern but also has many other determinants, which I am sure you are well aware of.

Senator LEVIN. Mr. Mahoney.

Mr. MAHONEY. I have never sat on a corporate board, but as a close observer of financial accounting and reporting for over a decade, certainly tax implications are a very important factor or feature to the structure of many, if not most, corporate transactions.

Senator LEVIN. If we close this gap and we have the tax return reflect the amount shown on the books for the value of the stock option when granted, at that point the taxpayer, the stock option holder who exercises that option down the road, if that stock goes up—which it obviously would need to, or else the option would not be exercised—will be paying a larger tax on a larger amount than the company got as a tax deduction. That does not trouble me particularly for the reason I gave, but it did trouble one of our witnesses.

Mr. Turner, if you get symmetry where you have described and I have described and you support and I support, does that eliminate asymmetry which is important or relevant as between the tax deduction given to the company and the taxable income to the option holder when that option is exercised?

Mr. TURNER. Again, I thought for a while about the question that you asked earlier this morning, and I guess my initial take is, no, I am not that troubled by it because, in fact, part of that gain is in essence a holding gain from the date that the vesting ended until the time period they actually exercise and sell their stock. So for that reason, I am not particularly troubled.

The other thing is that we have done research at Glass, Lewis that indicates 80 to 85 percent of these options are cashless exercises anyway, so as you appropriately noted this morning, it is not the company that is paying in the cash, if you will. So given the magnitude of the cashless exercise in these, which are really nothing more than turning it back into a bonus type cash payment, I really do not have a problem that that income is going to be a higher number. And certainly they have the cash in the pocket, if you will, if in fact it is higher.

If, on the other hand, the options are never exercised—and we all need to keep in mind that some of these options never are exercised—certainly then in that case the employee will not be getting taxable income for that because they would not have ever exercised.

Senator LEVIN. Professor Desai.

Mr. DESAI. Sir, I think it is useful to frame this as a transition from one kind of symmetry to another kind of symmetry. So the current symmetry is within the Tax Code for the corporate and the individual, and the symmetry you are talking about is at the corporate level between financial and tax.

As to whether I am bothered by the potential that the individual is going to have a larger income than we gave a deduction for, I do not think that is terribly problematic. I mean, in some sense, one way to think about this is if we believe symmetry—or if we believe the compensation happens at the time of grant, as accounting standard setters have suggested, then we are affording some relief to the income taxpayer by delaying the taxable event until the time of exercise, meaning the natural time, if we really believe the matching principle is important, then again at the time of grant under this new system. So there is actually some relief being afforded to that taxpayer, and I think in that setting, not just relief in terms of time, but also relief in terms of not having phantom income and also relief in the sense of only having a tax obligation in the good state in the world.

So all of that makes me think that these concerns can be mitigated.

Senator LEVIN. Mr. Mahoney.

Mr. MAHONEY. I have very little tax expertise, but my view would be that I do not think this is a significant problem. I would agree with my co-panelists.

Senator LEVIN. Just a few more questions. Let me ask you, Mr. Mahoney, this question. You described in your prepared statement some concerns with the new SEC disclosure rules for executive compensation, particularly how stock options are valued in the summary compensation table. You presented an example of a CEO who might be listed as receiving negative compensation. Would you just elaborate on that for a moment?

Mr. MAHONEY. The SEC's executive compensation disclosure rules, as originally adopted back in August, they require that stock and option awards be reported in this new summary compensation table at their full grant date fair value. That decision in the original final rules was consistent with the council's recommendations and the recommendations of many investors.

However, the SEC's December 2006 amendments to the original final rules made a change requiring that stock and option awards be reported in the summary compensation table in an amount equal to the dollar amount recognized in the financial statements in accordance with FAS 123R, though there are some exceptions to that as well.

By more directly linking the compensation disclosure in the proxy statement to the amount of compensation expense recognized under FAS 123R, that creates some circumstances where a named executive officer's reported stock-based compensation in the new summary compensation table can be negative. Now, those circumstances may occur, for example, when the change in the market value of an award that is classified as a liability award for FAS 123R purposes is negative in a period. That would be one example.

Another example would be where it becomes unlikely that the performance condition of a previously recognized performance-based award will no longer be achieved. That circumstance may also create a negative amount in the summary compensation table.

We believe that the SEC's December 2006 amendments are inconsistent with the use of proxy statements by shareholders because proxy statement disclosures are intended to provide investors with information to evaluate the annual decisions of the compensation committee. We believe that showing the full grant date fair value in the summary compensation table is the better way to report stock and option awards.

Senator LEVIN. Thank you. Do either of the other witnesses have a comment on that?

Mr. TURNER. At Glass, Lewis we obviously do recommendations on over 11,000 companies and their proxy and on this specific issue of the magnitude of compensation and the compensation committee, and I would just say that I think Jeff's understanding is very consistent with ours. Our large institutional investors, who manage over $10 trillion in value, typically want to assess the compensation committee based upon their decision in a particular year, and one of the key factors they use in making that assessment is the value of the options granted in that particular year. And, therefore, to get that information, they need the disclosure of the amount of the fair value of the options granted in that particular year.

When the SEC made the last-minute midnight change, if you will, just before Christmastime, they eliminated that transparency for institutional investors, and we heard time and time again from those how it made it much more difficult to analyze that table. So I would concur with what Mr. Mahoney said.

Senator LEVIN. Professor, do you have——

Mr. DESAI. Nothing.

Senator LEVIN. Let me now conclude with just a very brief comment.

We have received evidence today that companies are legally claiming tax deductions for their stock option expenses that are far in excess of the expenses actually shown on the books. Nine companies claimed $1 billion more in stock option deductions than they would have shown on their books even with the new stricter accounting rule that FASB has adopted for stock options. Altogether in 2004, companies claimed $43 billion more in stock option deductions than they showed on their books under that IRS data.

Right now, stock options are the only form of compensation where a company is allowed to deduct more than the expenses shown on its books. It is as if the Tax Code allowed a company to pay an employee $10,000 for their services and then deduct $100,000, 10 times as much. It contradicts common sense. It treats stock options differently from all other forms of compensation. It costs the Treasury billions of dollars each year. It creates an incentive for companies to give out huge stock option grants, further inflating executive pay compared to average worker pay and diluting the stock of other stockholders.

One solution which I favor is to make stock option tax deductions match stock option book expenses. Doing that would bring stock options into alignment with all other types of compensation in the Tax Code. It would save billions of dollars by revising an overly generous stock option tax deduction to make the deduction match actual book expenses. And I believe it would also eliminate a book-tax difference that encourages and gives incentives to hand out more stock options than companies otherwise would, which drives executive pay even higher compared to the pay of average workers. And it also is giving incentive for some companies to play games with the accounting rules and how they value stock options on their books, and that is something which we also ought to try to prevent.

In 2006, CEO pay averaged over $15 million with half coming from exercised stock options. CEO pay is now 400 times average worker pay. It is out of whack with average worker pay, and part of the reason is that accounting and tax rules for stock options are also out of whack. The best way, I believe the only way that I can foresee, to fix this problem is to bring stock option accounting and tax rules into alignment with each other. I introduced a bill to accomplish that back in 1997. I did it again in 2003. There was not a lot of traction at that time for either of those bills, mainly, I think, due to the battle which was raging over stock option accounting. Now that that accounting issue is resolved and the number is fixed, once it goes onto the books, as FASB has decreed, there is now a clear fixed number that goes on the books. Once one of the methods is used, we now, it seems to me, have no justification to have a different number in the books for the value of stock options than is taken by companies in their tax returns.

So we are going to try again. I think that the environment is now sufficiently different with the resolution of the accounting rule that we may be able to get the traction which was missing in prior years.

I was glad to hear from at least one of our witnesses in the first panel that that was OK with them, that companies were totally neutral on that subject—at least his company was. I look forward to neutrality on the part of all of our corporate community when this bill is forwarded. I say that with some irony. I am sure that we will not have total neutrality, but, nonetheless, we hope that companies and, most importantly, that stockholders and investors will see the value in having this symmetry finally between what the books show and what the tax returns show as well.

To our witnesses, you have been very helpful, forthcoming, thoughtful, and we appreciate all of your testimony, and we will stand adjourned.

[Whereupon, at 11:37 a.m., the Subcommittee was adjourned.]

APPENDIX

Statement Provided By
STEPHEN F. BOLLENBACH
Chairman of the Board of Directors, KB Home

KB HOME

June 1, 2007

Via email to Mary_Robertson@hsgac.senate.gov

The Honorable Carl Levin
Chairman
Permanent Subcommittee on Investigations
Senate Committee on Homeland Security and Government Affairs
340 Senate Dirksen Building
Washington, D.C. 20510

The Honorable Norm Coleman
Ranking Minority Member
Permanent Subcommittee on Investigations
Senate Committee on Homeland Security and Government Affairs
340 Senate Dirksen Building
Washington, D.C. 20510

Dear Chairman Levin and Senator Coleman:

In your letter dated May 21, 2007, you notified us that the U.S. Senate Permanent Subcommittee on Investigations (the "Subcommittee") would conduct a hearing on June 5, 2007 regarding executive stock options and current policies that require stock option compensation to be treated differently for accounting and tax purposes. That letter also requested a written response by KB Home (KB Home or the Company) with respect to six specific matters. Listed below are those six matters, along with the Company's responses:

1. <u>KB Home's policy and procedures for granting stock options to its executives, including the role of KB Home's Compensation Committee in approving general stock option plans and individual stock option grants.</u>

On February 1, 2007, the Management Development and Compensation Committee (the "Compensation Committee") of KB Home's Board of Directors adopted an Equity-Based Award Grant Policy (the "Grant Policy"). The Grant Policy sets forth KB Home's policies and procedures for granting stock options to its executives.

The Grant Policy requires all grants of equity-based awards, and their terms, to be approved by the Compensation Committee (or the Board of Directors), which the Grant Policy refers to as the "Granting Body." The Grant Policy does not permit any delegation of granting authority to management. The grant date of any equity-based award will be the date on which the Granting Body met to approve the grant unless the Granting Body by written resolution sets a later date. The exercise price of any stock option award will not be less than the price of KB Home's common stock on the grant date.

The Grant Policy, among other things, is designed to enhance the process by which KB Home grants equity-based awards, including stock options and restricted stock, and in doing so it addresses concerns identified in the recent internal Stock Option Review (defined and discussed separately below in response to matter #5). The Grant Policy is also designed to enhance KB Home's internal control over the processing, recording, external reporting, internal communication and administration of equity-based awards. The Grant Policy includes approval procedures for equity-based awards and establishes specific responsibilities for relevant KB Home personnel, with detailed recordkeeping requirements and multiple layers of review.

A full copy of the Grant Policy was included with KB Home's Current Report on Form 8-K filed with the Securities and Exchange Commission on March 19, 2007. A copy of that Form 8-K was included in the materials previously provided to the Committee.

KB Home's practices with respect to executive compensation, prior to the adoption of the Grant Policy, are described at length in the proxy statements filed by KB Home with the Securities and Exchange Commission from 1999 through 2006 (including the "Compensation Committee Reports on Executive Compensation" contained therein); stock plans used by KB Home during the years 1999-2006, from which stock-based executive compensation was granted; and the Form 10-Ks filed by KB Home with the Securities and Exchange Commission from 1999-2006, which include information related to stock options granted by KB Home. In addition to these materials, KB Home's practices are also reflected in various other materials provided to the Subcommittee, including the 1999-2006 Minutes of the Meetings of the Compensation Committee of the Board of Directors of KB Home, the 1999-2006 Minutes of the Meetings, and the Form 10-Q and Form 10-K filed by the company with the Securities and Exchange Commission on February 13, 2007. Rather than provide an incomplete and potentially inaccurate summary of those practices, KB Home will respectfully refer the Subcommittee to those previously provided materials.

2. The number of stock options awarded to KB Home's former chief executive officer (CEO) Bruce Karatz each year since 1998; the value of each such stock option grant at the time of the grant; the number of stock options exercised by Mr. Karatz each year since 1998; the gain in dollars obtained from each such exercise; and the number of unexercised stock options still in his possession as of the end of 2006.

KB Home has previously provided tables to the Subcommittee listing the number of stock options granted to Mr. Karatz during calendar years 1999, 2000, 2001, 2002, 2003, 2004, 2005, and 2006. Those tables also listed the number of stock options held by Karatz at the end of each of these years; the total number of stock options exercised by Karatz during each year, and the total amount of dollar gains Karatz obtained during each year from such exercises. Rather than provide an incomplete and potentially inaccurate summary of those tables, KB Home will respectfully refer the Subcommittee to those previously provided materials.

3. <u>With respect to the CEO stock options that were exercised from 2002 to 2006, how the stock option compensation expense was reported on KB Home's financial statements under Generally Accepted Accounting Principles; how the same compensation was reported as a business deduction on KB Home's tax returns; and what the differential was between the two figures.</u>

Following extensive discussions with the Subcommittee Staff, KB Home has previously provided tables to the Subcommittee showing this information for the years 2004 and 2005; KB Home's former CEO did not exercise any stock options in 2002, 2003 or 2006. The Subcommittee has in turn produced its own chart based upon the information provided by KB Home and KB Home has now confirmed the data contained in the Subcommittee's own chart. Rather than provide an incomplete and potentially inaccurate summary of those tables, KB Home will respectfully refer the Subcommittee to those previously provided materials, as well as the Subcommittee's own chart.

4. <u>How Financial Accounting Standard 123R would have affected the reporting of that stock option compensation on KB Home's financial statements had it been in effect when the stock option grants were made.</u>

The grant date fair value of the stock options was reported in a note to KB Home's consolidated financial statements. Had Financial Accounting Standard 123R been adopted by KB Home during this period, KB Home would have reported these fair values as stock-based compensation expense, an adjustment to the selling, general and administrative expense line item in its consolidated statements of income instead of in the notes to these consolidated financial statements.

5. <u>The circumstances surrounding KB Home's involvement with stock option backdating and the restatement of its financial statements.</u>

On July 25, 2006, KB Home commenced a voluntary independent review of our stock option grant practices (the "Stock Option Review") to determine whether we had used appropriate measurement dates for, among other awards, the twelve annual stock option grants we made from January 1995 to November 2005. The Stock Option Review was directed by a subcommittee of our Audit and Compliance Committee (the "Audit Subcommittee") — consisting solely of outside directors who have never served on our Compensation Committee — with the advice of independent counsel and forensic accountants. The Audit Subcommittee and its advisors conducted 66 interviews, including seven with current and former members of our Compensation Committee, and collected more than 1.2 million documents relating to the Company's stock option grant practices from 64 individuals.

On November 12, 2006, KB Home announced that the Audit Subcommittee had substantially completed its investigation and concluded that the Company had used incorrect measurement dates for financial reporting purposes for the eight annual stock option grants made since 1998. At the same time, KB Home announced the departure of its Chairman and Chief Executive Officer and its head of human resources.

The evidence developed through the Stock Option Review indicates that KB Home's Compensation Committee met in October each year since 1998 to consider and approve annual stock option awards for the next year. At those meetings, the Compensation Committee specifically approved the number of stock options to be granted to the former Chief Executive Officer and other senior management, as well as an unallocated block of stock options to be allocated by the former Chief Executive Officer and the former head of human resources to other employees.

In addition to allocating annual stock options among other employees, starting with the annual stock option grant approved by the Compensation Committee in October 1998, the former Chief Executive Officer and former head of human resources also selected the grant date. The Audit Subcommittee discovered evidence confirming or, in some years, suggesting that hindsight was used to secure favorable exercise prices for seven of the eight annual stock option grants since 1998.

Based on the evidence developed through the Stock Option Review, senior management involvement in, and knowledge of, the hindsight pricing practices was limited to the former Chief Executive Officer and the former head of human resources. The Audit Subcommittee concluded that these hindsight pricing practices did not involve any of KB Home's current senior management, including the Company's new Chief Executive Officer, its principal financial officer, or its principal accounting officer, nor were any of those individuals aware of these practices. The Audit Subcommittee further concluded that none of KB Home's other accounting or finance employees were involved in, or aware of, the hindsight pricing practices.

Based on the findings of the Audit Subcommittee, KB Home changed the measurement dates for the annual stock option grants since 1998 from the grant dates selected by its former Chief Executive Officer and its former head of human resources to the dates KB Home's employees were first notified of their grants. These measurement date changes resulted in an understatement of stock-based compensation expense arising from each of the Company's annual stock option grants since 1998, which affected KB Home's consolidated financial statements for each year beginning with the year ended November 30, 1999.

KB Home has determined that the aggregate understatement of stock-based compensation expense for the seven-year restatement period from 1999 through 2005 was $36.3 million. In connection with the restatement of its consolidated financial statements to reflect the stock-based compensation adjustments associated with the stock option measurement date changes, KB Home also recorded an aggregate increase of $4.8 million in its income tax provision for the seven-year restatement period. This amount represents the cumulative income tax impact related to Internal Revenue Code Section 162(m), partially offset by the income tax impact of the additional stock-based compensation expense. The stock-based compensation expense and related income tax impacts reduced net income by $41.1 million for the years ended November 30, 1999 through 2005. The related tax effects on our consolidated balance sheet include an increase of $72.3 million in accrued expenses and other liabilities, and a decrease of $77.8 million in stockholders' equity.

All of this information is contained in the Form 10-Q and the Form 10-K filed by KB Home with the Securities and Exchange Commission on February 13, 2007, each of which include an extended discussion of the options issues at the Company and the resulting restatement of the Company's financial statements. KB Home has previously provided these filings and other related materials to the Subcommittee.

6. KB Home's views, if any, regarding current policies that require different accounting and tax treatment of stock option compensation.

KB Home has no views regarding this matter and will abide by whatever additional laws or regulations are promulgated with respect to it.

Sincerely yours,

Lawrence B. Gotlieb

Lawrence B. Gotlieb
Vice President
Government and Public Affairs
Associate General Counsel

**TESTIMONY OF JOHN S. CHALSTY
CHAIRMAN, EXECUTIVE COMPENSATION
AND HUMAN RESOURCES COMMITTEE OF THE
BOARD OF DIRECTORS OF OCCIDENTAL PETROLEUM CORPORATION,
BEFORE THE U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS**

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

Thank you for inviting me to participate in today's hearing. I look forward to a constructive dialogue about these issues.

My name is John S. Chalsty. I have spent most of my professional career working in investment banking and finance. From 1986 to 1996, I served as President and Chief Executive Officer of Donaldson, Lufkin & Jenrette, Inc., and I served as Chairman of that firm from 1996 to 2000. Since 2003, I have been Chairman of Muirfield Capital Management LLC, an asset management firm. Since 1996, I have served on the Board of Directors of Occidental Petroleum Corporation, and I currently serve on the Board of Directors of several other companies in a variety of industries. In connection with my service on the Board of Directors of Occidental Petroleum Corporation, I currently serve as Chairman of Occidental's Executive Compensation and Human Resources Committee, generally referred to as the Compensation Committee.

Introduction

Before discussing generally Occidental Petroleum Corporation's policies and procedures regarding stock options, I would like to emphasize two important points. First, the Compensation Committee only grants stock options pursuant to plans that have been approved by Occidental's stockholders, and the company fully discloses to its stockholders the granting of such stock options as required by law and regulation. The granting of stock options to officers and employees of Occidental Petroleum Corporation is a longstanding practice that is well-understood by the company's stockholders, who have seen the company's management transform and re-focus Occidental from 1990 to 2006. During that period, the company has increased core profits from $191 million to more than $4.3 billion, reduced debt by 65% from more than $8 billion to less than $3 billion, and increased its stock market value by 650% to $41 billion. Occidental's transformation increased the oil and gas sales from 17% of total sales in 1990 to 72% in 2006. The use of stock options as a part of the company's compensation program is not a surprise to our stockholders, the investment community, regulators, or the public.

Second, throughout this period the company's treatment of stock options for both tax and accounting purposes complied fully with all applicable laws, rules, and regulations – and no one has contended otherwise. Prior to the adoption of Statement of Financial Accounting Standard ("FAS") No. 123R on July 1, 2005, Occidental Petroleum Corporation accounted for stock awards pursuant to APB 25. Because all stock options awarded by Occidental are granted "at the money," there was no "intrinsic value" to record as expense at the time of the grant. Beginning on July 1, 2005, Occidental Petroleum Corporation accounted for stock awards, as all companies are now required to do, pursuant to FAS 123R and reported their "fair value" as expense in its publicly available financial statements. No stock options were ever backdated, and no restated SEC financial statement filings have been required in the last 15 years.

Likewise, Occidental Petroleum Corporation has complied fully with all federal, state, local and foreign tax laws and has deducted from its tax returns only those amounts related to employee stock option exercises as is permitted by law. The result of this compliance with the law has been that over the past five years, from 2002 to 2006, Occidental has paid more than $4 billion in corporate income taxes in the United States. In sum, Occidental Petroleum Corporation is a successful United States company that complies with the law and pays substantial taxes. Again, no one has contended to the contrary.

Occidental's Policies and Procedures for Granting Stock Options

As the Subcommittee has requested, I would like to provide a brief overview of Occidental Petroleum Corporation's policies and procedures for granting stock options to its executives. Stock options are granted by the Compensation Committee of the Board of Directors. Pursuant to its written charter, the Compensation Committee is made up entirely of independent directors. Among other things, the Compensation Committee makes recommendations to the Board of Directors with respect to incentive-compensation plans and equity-based plans and administers the stock-based compensation plans of the Corporation that have been adopted by the Board from time to time. The Compensation Committee performs many tasks in connection with this role, including, but not limited to, selecting participants, making grants and awards, setting performance targets, and interpreting the terms and provisions of the Plans. The Compensation Committee, as it deems appropriate, may engage special legal or other consultants to report directly to the Committee.

All new stock plans and amendments to existing stock plans must be reviewed by the Compensation Committee before being submitted to Occidental's Board of Directors for approval. In making its recommendation to the Board of Directors, the Compensation Committee takes into consideration the potential dilutive effect of such awards, as well as changes in compensation practices. New stock plans and any material amendments to existing stock plans must be approved by Occidental Petroleum Corporation's stockholders before they can be implemented.

Occidental's Compensation Committee grants stock awards, including stock option awards, at regularly scheduled meetings normally held the day before regularly scheduled Board meetings. The Board's regularly scheduled meeting dates are set in the prior year. For approximately the past ten years, stock option grants have been made at the Compensation Committee's July meeting. As I mentioned earlier, no stock options granted by Occidental have been backdated.

Accordingly, the exercise price for stock options is determined using the closing price on the New York Stock Exchange on the date the award is made by the Compensation Committee. As such, the intrinsic value of the options on the date of the grant is zero. Occidental's stock plans do not permit re-pricing of options without the approval of stockholders, and Occidental has not re-priced options. The stock options granted by Occidental Petroleum Corporation vest one-third each year over a three year vesting period. The options are exercisable for a ten-year term and are subject to forfeiture in certain events, such as termination of employment for cause. In making grants to the executive officers named in the proxy statement, the Compensation

Committee considers personal performance, industry practices, prior award levels, outstanding awards, and overall Occidental stock ownership in an effort to foster a performance-oriented culture and to align the interests of executive officers with the long-term interests of the company and its stockholders. Grants to other employees are reviewed and approved by the Compensation Committee taking into consideration management's recommendations.

Differences Between Treatment of Stock Options Under the Accounting and Tax Rules

As I mentioned at the beginning of my testimony, Occidental Petroleum Corporation complies fully with both the accounting and tax rules with respect to stock options. From an accounting perspective, pursuant to FAS 123R, on July 1, 2005, Occidental began recognizing fair value compensation expense for stock options. Compensation is measured on the grant date using the Black Scholes option valuation method, and the expense is recognized for accounting purposes on a straight-line basis over the requisite service period, which is generally the option's vesting period.

With respect to Occidental's federal tax returns, in accordance with IRS regulations, Occidental reported deductions in its corporate tax returns for non-qualified stock options in the year they were exercised. For non-qualified stock options, the amount of Occidental's corporate tax deduction in the year of the option's exercise is the same as the amount included in taxable income by the exercising executives on their individual federal income tax returns, that is, the difference between the fair market value at exercise and the option exercise or strike price.

Occidental recognizes stock option compensation expense in its financial statements in accordance with the applicable Generally Accepted Accounting Principles in effect at the time the financial statements are prepared. Likewise, Occidental reports the tax treatment of stock option compensation expenses in accordance with the applicable tax laws and regulations in effect when the tax returns are prepared. Any variations in the expenses recognized in the financial statements and the deductions reported in the tax returns are a result of the differences between the applicable accounting and tax regulations.

The accounting rules and the tax rules are designed to pursue different objectives using different approaches with frequently different results. The accounting rules are based on the matching principle where in this case the value of the options is expensed over the service period. The tax rules defer the value of the stock options until the date that the employee realizes the benefit of the option by exercising them. These different perspectives, not surprisingly, produce different results for different purposes. I cannot say that one is "right" and the other "wrong." What I can say with certainty is that Occidental has complied, and will comply, with whatever accounting and tax regulations the respective accounting and tax standard-setters apply to the granting and exercising of stock option awards.

Conclusion

Thank you again for the opportunity to testify at today's hearing. I would be happy to answer to the best of my ability any questions that you may have.

Written Statement of William Y. Tauscher

Board Member and former Chair, Executive Compensation Committee of

Safeway Inc.

Introduction and Summary

I am William Y. Tauscher, appearing today on behalf of Safeway Inc. ("Safeway" or the "Company"). I have been a member of the Board of Directors of Safeway since 1998 and also a member of Safeway's Executive Compensation Committee since 1998. I served as Chair of the Executive Compensation Committee from 1998 until 2006. Besides being a Safeway director, I am the Managing Member of The Tauscher Group, which invests and assists in the management of enterprises involved with home products, transportation, security and real estate. I am also the Chairman and Chief Executive Officer of Artisoft, Inc. (d/b/a Vertical Communications, Inc.), a public communications technology company. I have previously been Chairman and Chief Executive Officer of Vanstar Corporation, a public computer services company, and before that Chairman and Chief Executive Officer of FoxMeyer, a public nationwide health care distributor. I also have invested in and helped manage several investments with private equity institutional partners.

On behalf of Safeway, I am pleased to accept the Subcommittee's invitation to provide testimony on Safeway's executive stock option compensation practices so that the Subcommittee may examine current tax and GAAP accounting policies in this area. As we understand it, the purpose of this hearing is to review the differences between accounting rules and tax rules in their treatment of stock option compensation. Safeway is not here to advocate for current accounting or current tax policy, or changes in those policies. We adhere to the laws and regulations set by Congress and other bodies and ensure that our financial and tax reporting are of the highest integrity. I do believe, however, that the Subcommittee will benefit from important background and context in evaluating how the current accounting and tax policies for stock option compensation are implemented at a corporation like Safeway.

Safeway is one of the largest food and drug retailers in North America – operating approximately 1,750 stores in the United States and Canada. Our revenues in 2006 were $40.2 billion, and we have about 200,000 employees. It has received national recognition and awards for environmental stewardship, sustainability, social responsibility and leadership in positively impacting the communities it serves through more than $150 million in charitable contributions annually.[1] We received a corporate governance rating of 93.1 from Institutional Shareholder Services, which is intended to convey that our corporate governance is better than 93% of the companies in the S&P 500. The Company has also been instrumental in advancing important public policy discussions. Safeway has recently taken a lead position among American businesses to advance health care reform, building a coalition of nearly 50 large companies. The purpose of the coalition is to offer a comprehensive health care solution by providing coverage for the 47 million uninsured citizens and bringing down per capita costs so that health care is more affordable. Safeway is working closely with its largest union, the UFCW International, which shares these same objectives.[2]

Safeway's Compensation Program

Our compensation program has been instrumental to our success. Safeway's Executive Compensation Committee has designed its compensation program to attract and retain the best management. Our compensation program closely links the compensation of Company executives with the Company's financial performance and substantially aligns that compensation with the long-term interests of stockholders. Because of that linkage, our Board has been able to retain for nearly 15 years one of the best CEOs in corporate America.

Under Steve Burd's leadership, the Company has outperformed 97% of the companies listed in the S&P 500 over the last 14.5 years.[3] The compound annual growth rate of Safeway's stock price over this time period, at 19.8%, has been twice that of the S&P 500. Safeway has outperformed many outstanding U.S. companies during this period, including Intel, Hewlett-Packard, Wells Fargo, Apple and General Electric. From 1992 to 2006, the Company's market capitalization increased from $1.3 billion to $15.2 billion. During that period, the Company's annual net income increased from $43.5 million to $870.6 million, an increase of approximately 2,000%. The Company's annual earnings per share during that period increased from $0.09 to $1.94. These are extraordinary accomplishments considering the maturity of the sector and the nature of its competition. And this has been accomplished while helping the communities we serve by donating or raising more than $1.25 billion in cash or goods, or 18.2% of net income, to charitable organizations.

The Company's recent performance has been excellent. In 2006, the return on an investment in our stock was 47%, about three times the 15.8% return experienced by the S&P 500. An article in Bloomberg News last month noted that Safeway's performance since 2004 was better than 75% of the companies in the S&P 500, and in 2006 was in the 94th percentile.[4] The article went on to point out that Safeway's performance in 2006 was actually twice as good as Safeway's peer group.

The Role of the Compensation Committee

We compete with this peer group of companies and numerous other companies for executive talent, and therefore we need to pay at market levels. The task for the Compensation Committee is to keep an eye on compensation levels at comparable companies and to determine how to reward for extraordinary results. At Safeway, the Committee intentionally sets executive salary levels slightly below market, and uses bonuses and stock options to provide compensation slightly above competitive norms when the Company performs well. Even given the recent success of the Company, Mr. Burd's compensation has been within the lower range of large companies in the United States. His 2006 total compensation ranks in the bottom 10% of companies in the S&P 100, and his equity compensation ranks in the bottom 5% of that group.[5]

Because of the Company's success over the past 10-15 years, Mr. Burd's stock options have increased in value, and he has been rewarded along with other investors in

Safeway's stock. Unlike many other CEOs, Mr. Burd behaves like a long-term stockholder and typically holds his options until the end of the option term – historically, 10-15 years. By doing so, he often misses out on opportunistic peaks in the share price. This practice also causes the options to produce gains at a single point in time, rather than spread out over many years, and these gains may not coincide with a good performing year for the Company. For example, Mr. Burd's 2003 and 2004 option exercises occurred at relatively low price points for the Company's stock. This was not an opportune time to exercise the options, but the term was expiring. When looking at these blocks of exercised options, it is important to consider them as a 10-year compensation instrument and not associate them with one year's performance in the year of exercise.

Much of the criticism leveled at executive compensation these days relates to extraordinarily large severance packages that are given to CEOs upon their departure. Safeway is proud of the fact that none of its executive officers has an employment contract or a severance agreement. The CEO and other executive officers serve at the will of the Board. If our CEO were terminated for any reason, we would have no obligation to pay him any severance. In this respect, Safeway is unusual, if not unique, among large public companies.

Accounting and Tax Treatment

With respect to accounting rules, Safeway adopted SFAS No. 123R, the accounting rule governing the expensing of stock options, in the first quarter of 2005, a year before U.S. companies were required to do so. With the advice of expert independent consultants, Safeway has used the Black-Scholes methodology for valuing options for expense purposes, by far the most commonly used methodology for this purpose. SFAS No. 123R requires a company to value options at the grant date and expense that value evenly over the vesting period. Subsequent to vesting, if the employee has realized a gain from exercising the option, the tax rules require the employee to recognize taxable income at the time of exercise, while the company takes a corresponding tax deduction at that time.

We understand the Subcommittee is examining several issues at this hearing, including how a company's accounting expense for stock options, determined using Black-Scholes or other options valuation methodologies, compares with the tax deductions a company takes when those options are exercised. We have three principal observations on those issues.

First, any evaluation of the accounting expense for stock options should appropriately focus on all option grants, not merely option exercises. A snapshot comparing the accounting expense for exercised stock options to subsequent tax deductions for specific option exercises will result in a distorted picture. For example, such a comparison will not account for the expensed amounts on options that are never exercised because they expire with the exercise price higher than the company's current stock price. Thus, such a snapshot might exaggerate what seems, at first, to be a disparity between the accounting expense and the tax deductions.

Second, the Subcommittee should assess this issue across a broad range of companies. The disparity between accounting expense and tax deductions will be greatest in companies that have outperformed their historical performance. By contrast, the accounting expense may significantly exceed tax deductions in companies that have underperformed their historical performance. A more accurate assessment of this issue requires an examination of numerous companies – outperformers and underperformers.

Third, the Subcommittee should not view the exercise of an option in a particular year as compensation simply for that year. When an option is exercised, the executive will receive the benefit of the appreciation in the value of the company's stock since the grant of the option. This may represent compensation for the executive's service for many years, possibly a decade or more, especially when the executive exercises the option at the end of the option term. The extraordinary growth in Safeway stock value from 1992 through 2006 resulted in a very significant value for options granted early in that period. This extraordinary increase in value is properly viewed as the result of more than ten years of effort to improve stockholder value, and obviously not as compensation for efforts solely in the years of exercise.

To summarize, I hope Safeway's participation today helps illuminate these accounting and tax policy rules for the Subcommittee. Again, we at Safeway offer no view today on what those accounting and tax rules should be in the future. We are committed to diligently following the rules, whatever they may be.

Safeway Executive Compensation Policy and Policies for Stock Options: Additional Detail

A. Objectives of the Compensation Programs

Safeway's compensation programs for our executive officers are designed to attract and retain excellent managers, and to motivate these managers to increase the market value of our stock over the long term. In support of these principal objectives, the compensation programs are designed to:

- Provide our executives with base salaries, retirement and other benefits that are competitive with those provided by other companies with whom we compete for executive talent;
- Pay annual bonuses that reward our executives for the attainment of our annual financial, operational and strategic goals;
- Grant our executives equity-based compensation that will motivate them to improve our long-term performance and, specifically, to increase the market value of our stock price over time, in addition to helping retain those executives; and
- Motivate our executives to improve their individual performances.

Our executive salaries at Safeway are slightly below the median for comparable companies, but executives can make slightly above the median if the Company outperforms its peers. We place great emphasis on the objective of improving corporate performance and thereby increasing the long-term market value of our stock. We believe these policies help align the interests of our executives with those of our stockholders, and advance our objective of increasing stockholder returns.

B. Stock Options.

We believe stock options provide an incentive for our employees to increase the long-term market value of the Company, as represented by its stock price. Prior to 2005, the Company granted stock options periodically, such as at the time of hire or promotion, or for retention purposes. Today, we have an annual grant program under our Long-Term Incentive Plan ("LTIP"). As in many other companies, the purpose of our LTIP is to encourage our executives to improve the long-term value of the Company, while also serving as a method for retaining our executives. Our LTIP involves annual grants of stock options to our eligible employees. Compared to other LTIP programs that may involve a mix of cash and equity vehicles, we believe our stock-option-based LTIP most effectively focuses long-term performance on the objective of share price appreciation and aligns the interest of management with that of the stockholders.

Under the LTIP, the Compensation Committee makes annual grants of stock options based upon various factors, including the employee's base salary, competitive levels of long-term incentive compensation and Company performance over the last several years. Examining competitive data ranges of compensation levels around the median peer group level, using the Black-Scholes value of Company stock options and taking into account recent Company performance, the Compensation Committee determines appropriate amounts of long-term incentive compensation to be paid to the employees.

The Compensation Committee, or the Board, has the sole authority to make stock option grants to executive officers. The Committee generally will authorize grants to such officers only at a meeting, and the option grant dates selected will be no earlier than the date of the meeting. Earlier this year, the Compensation Committee approved LTIP option grants to Safeway officers at a meeting in February, and it selected as the option grant date the first day of our insider trading window period following the meeting, which occurred later in February.

Mr. Burd's Compensation and Stock Options

The base salary of Steve Burd, our Chief Executive Officer ("CEO"), is determined annually by the Board of Directors. At the end of each fiscal year, our Lead Independent Director collects information regarding Mr. Burd's performance and discusses relevant issues with him. The Lead Independent Director then reports on his or her findings and discussions to the Compensation Committee, which reviews Mr. Burd's salary each year. The Compensation Committee periodically obtains information regarding the compensation of the chief executive officers of our peer group companies. The Compensation Committee then meets, without Mr. Burd present, and makes a recommendation to the Board about Mr. Burd's base salary for the next fiscal year. The Board subsequently meets in executive session, without Mr. Burd present, and conducts a formal performance review of Mr. Burd, and sets his base salary for the next fiscal year. Other regular elements of compensation for Mr. Burd – bonus levels and long-term incentive equity award grants – are also established by the Compensation Committee and the Board in conformity with our general compensation principles. During the years 2001-2004, Mr. Burd did not receive any stock option grants. In 2002 and 2003, Mr. Burd received no bonus under the Company's Operating Performance Bonus Plan. In 2003, he elected to forgo his bonus under the Company's Capital Bonus Plan.

Last month, Graef Crystal, a respected compensation consultant, wrote an article for Bloomberg News praising Safeway's and Mr. Burd's performance and discussing Mr. Burd's compensation as compared to that performance.[6] The article indicated that in light of the fact that Mr. Burd "help[ed] [the Company's] stock deliver a 47% return in 2006" "investors get Safeway['s] CEO for sale price." The report noted that Safeway's performance since 2004 was better than 75% of the companies in the S&P 500 index, and in 2006 was in the 94th percentile. The article then noted: "[f]or that fabulous performance, Mr. Burd was paid well, but, comparatively speaking, not that well. His total remuneration . . . was 39% below the competitive standard based on 438 companies with market values of US $3 billion or more" and 22% below the Company's peer group, despite performance that was approximately twice as good. The article also praised Mr. Burd's and the Company's good performance and Mr. Burd's below-market compensation package in prior years as well. It also commented favorably on Mr. Burd's Safeway stock holdings. Mr. Burd currently holds more than 460,000 shares of Safeway stock, giving him a large stake in the future success of the Company.

Mr. Burd was granted options in 1992, when he joined the Company, and in 1994, shortly after he became CEO. Mr. Burd exercised a small fraction of the 1992 options and all of the 1994 options 10 years later, in 2002-2004. At the time of exercise, the 1994 options were at or near expiration. Had Mr. Burd exercised these options in earlier years, his gains could have been significantly higher, but his general practice was to hold the options until near the expiration dates. This practice caused him to exercise many of his options in 2003 and 2004, when the Company's stock price was relatively low. Nevertheless, at the time of exercise – roughly ten years after the grants were made – Mr. Burd's options had gained considerable value. As explained above, since 1992, the Company has performed extremely well. The value of Mr. Burd's options resulted from the Company's performance over that entire span of years during which Mr. Burd led and managed the Company. It would not be appropriate to consider the gains on these options as "compensation" only for the specific years in which they were exercised.

Statement of Financial Accounting Standards No. 123R and Black-Scholes

Safeway applies U.S. generally accepted accounting principles for purposes of reporting stock option compensation expenses in the Company's financial statements. Prior to 2005, the Company's stock option compensation expense was determined under APB Opinion No. 25, Accounting for Stock Issued to Employees. In general, no stock option compensation expense was reported by the Company for stock options subject to APB Opinion No. 25 because the per share exercise price of the stock options was the fair market value of the stock on the grant date of the stock option.

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123R. The Company elected to early adopt SFAS No. 123R in the first quarter of 2005. SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options after January 1, 2005, to be recognized in the financial statements as compensation cost based on the fair value on the date of grant. Safeway determines fair value of such awards using the Black-Scholes stock option pricing method. An independent third party assists the Company in determining the Black-Scholes assumptions utilized in the valuation of stock options.

Under SFAS No. 123R, Safeway reports stock option compensation expense for all options granted based on the vesting period of the stock option. The stock option compensation expense for a period equals the portion of the fair value attributable to the portion of the stock option that vests during the period. For example, currently the Company's stock options generally vest over a five year period at the rate of 20% on each anniversary of the grant date of the stock option. In the case of a stock option subject to SFAS No. 123R, 20% of the fair value of the stock option on the grant date is reported as stock option compensation expense each year of the vesting period. This stock option compensation expense is reported without regard to the fair value of the stock option during the vesting period, and without regard to whether the stock option is ever exercised. This stock option compensation expense is reported even if the exercise price exceeds the Company's stock value when the stock option vests (and thus has no value to the employee).

Comparing Hypothetical Expensing of Options granted in 1992-94 with Tax Deductions taken in 2002-04

Accounting principles and tax laws have different objectives and often treat the same items differently. For example, stock options, depreciation, pension expense, asset impairment and workers compensation -- to name a few – are all treated differently for accounting and tax purposes.

Black-Scholes is one of the most popular methodologies for valuing stock options at the date of grant. However, no methodology will necessarily assign a value to a stock option grant that equals the amount of the tax deduction relating to the exercise of the stock option. Key inputs to Black-Scholes and other valuation methodologies are current stock price and historical stock performance. Companies that perform better in the future than they have in the past will likely have greater tax deductions than accounting expense. Conversely, companies with declining performance will probably have greater accounting expense than tax deductions. The eventual tax deduction received by companies for option grants is highly dependent upon stock price performance, so at the time of award, it would be impossible for the regulators to assess the tax deduction received by Safeway. Presumably, accounting expense and tax deductions will be approximately the same given a large enough sample of companies and if all options are measured, not just exercised options. In evaluating the accounting expense methodologies under SFAS No. 123R, we urge the Subcommittee to review a broad range of data for many companies before reaching any conclusions. In particular, such an examination should include within its scope both options exercised and options granted and expensed but not exercised. Only by looking at the entire range of options granted for an appropriate sample of companies can an appropriate evaluation be done.

We understand that the Financial Accounting Standards Board (FASB) considered and rejected accounting for stock options in a manner similar to the tax treatment. The FASB believed that the value of options should be measured when all of the terms of the options are set rather than when the options are exercised.

Conclusion

Thank you once again for the opportunity to provide our views on these issues. I hope this material has been useful to the Subcommittee.

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[1] The Company has received a number of awards in recent years in recognition of its social and environmental commitment and efforts, including, but not limited to: *Catalyst Award*, presented annually to three companies for initiatives that advance women in the workplace; *Red Cross – Circle of Humanitarian Award*, presented for raising $3 million for the South Asian Tsunami relief effort; *Easter Seals Chairman's Corporate Roundtable Award*, presented for raising $1.6 million for Easter Seals and its local affiliated agencies, which serve people with disabilities and their families; *Project Open Hand – Most Outstanding Partner Award*, presented for its record of assisting Project Open Hand, which provides home-delivered hot meals to AIDS victims and the homebound in the San Francisco Bay Area; *Green Power Leadership Award*, presented for the Company's leadership in purchasing wind energy to power a range of different stores and fuel stations in the United States; and the *Proggie Award*, presented by the People for the Ethical Treatment of Animals for the Company's requirement that its private label suppliers not use animal testing in the manufacture of cosmetics or household goods.

In addition, since July 2002, Safeway has been included in the Domini 400 Social Index maintained by KLD Research and Analytics, Inc. To be included in the Domini 400 Social

Index, companies must exhibit positive records with regard to the environment, community relations, human rights, product quality and safety, diversity, employee relations and corporate governance.

Safeway is also an industry leader in philanthropy. During 2006, the Company donated more than $110 million worth of merchandise to food banks and various hunger-relief agencies, bringing the Company's total food donations over the past decade to more than $1 billion. In 2006, the Company also contributed $22 million to schools through educational programs. In addition, the Company has donated a combined $22.3 million through major fundraising campaigns to support breast and prostate cancer research, treatment and education and to further the important work of the Muscular Dystrophy Association and Easter Seals.

The Company maintains Diversity Advisory Boards in each of its operating areas whose mission is to recognize, celebrate and benefit from the uniqueness of each employee and customer, to value, respect and support these differences in the workplace and to reflect this diversity in the communities we serve. In early 2007, the Company was featured in *HR Magazine's* cover story as a corporate innovator in diversity efforts to help develop and elevate women within the Company.

[2] The Coalition to Advance Healthcare Reform (CAHR), chaired by Steve Burd, is an active working coalition of more than 50 businesses, employers and other like-minded leaders committed to reforming the nation's healthcare system by 2009. Through this newly formed organization, the business community is joining together with other leaders and organizations to advance meaningful, market-based solutions to our nation's healthcare crisis. By advancing a set of core principles to guide and shape policies, the coalition can be instrumental in helping advance solutions that reverse rising healthcare costs, solve the problem of the uninsured and dramatically improve the quality of care for every American. More information about CAHR can be found at www.coalition4healthcare.org.

[3] Based on the compound annual growth rates for the S&P 500 index since October 13, 1992. Safeway was included in the S&P 500 index beginning in November 1998.

[4] *Safeway Shareholders Underpay for Star Performer,* Graef Crystal, Bloomberg News (May 14, 2007).

[5] As reported in 2007 proxy statements by companies using the new SEC disclosure rules, and whose CEOs were in office for all of 2006. With those qualifications, the sample group consisted of 78 companies.

[6] Id.

WRITTEN TESTIMONY OF THE ACTING COMMISSIONER OF INTERNAL REVENUE KEVIN BROWN BEFORE SENATE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS PERMANENT SUBCOMMITTEE ON INVESTIGATIONS HEARING ON BOOK-TAX DIFFERENCES WITH EXECUTIVE STOCK OPTIONS

JUNE 5, 2007

Good morning Chairman Levin, Ranking Member Coleman and members of the Permanent Subcommittee on Investigations. I am pleased to appear before you to discuss executive stock options and the differences that arise between financial statements that are provided to shareholders and the public and the corporate tax returns filed by the company. I also appreciate Chairman Levin's and Senator Coleman's interest and their assistance, in not only this area, but also in other areas related to the enforcement of our Federal tax laws.

Background

There are two general types of employee options recognized in the tax code, "qualified" and "nonqualified". Qualified (or "statutory") options include "incentive stock options," which are limited to a total cap of $100,000 a year for any one employee, and "employee stock purchase plans," which are limited to $25,000 a year for any employee. Employee stock purchase plans must be offered to all full-time employees with at least two years of service; incentive stock options may be confined to officers and highly paid employees.

Under the Code, tax on qualified options is imposed on the executive employee only when the stock is sold, not when the options are granted or when the employee exercises the option. If the stock is held one year from purchase and two years from the granting of the option, the gain is taxed as long-term capital gain. The employer is not allowed a deduction for these options. However, if the stock is not held the required time, the employee is taxed at ordinary income tax rates and the employer is allowed a deduction.

In contrast to qualified options, nonqualified options (or non-statutory options) may be granted in unlimited amounts. Generally, it is these types of options that have given rise to significant corporate governance issues as key executives are provided substantial options that can be earned without regard to the relative performance of the employer in comparison to peer companies. For example, a key executive could be earning substantial income from the exercise of stock options while the return to shareholders either remains constant or even declines.

Nonqualified options are taxed when exercised. Tax is based on the difference between the purchase price for the stock and its fair market value at exercise. The company is allowed a deduction for the same amount in the year of exercise. The income is also subject to employment taxes.

Tax Administration and Corporate Governance

It is important to distinguish between tax administration and the oversight of corporate governance. The IRS is responsible for tax administration; our colleagues at the SEC focus on governance per se more directly than does the Service. Nevertheless, it is critical that we work together to the extent possible under existing law.

From a tax administration standpoint, unlike a financial accounting standpoint, we are generally unable to identify most executive compensation tax issues until a return is filed and an examination is started. Therefore, it is difficult for the IRS to address stock option issues before they have become known through the media or identified by others, such as institutional shareholders, research analysts, or the SEC, unless a return has already been filed and examined. We are generally precluded from sharing information derived from a tax return or audit with the SEC or other government agencies by IRC section 6103 except in limited, prescribed circumstances.

In addition, tax provisions that might be expected to have an impact on corporate governance may, for a number of reasons, not always have the impact that had been anticipated when they were drafted. For example, Section 162(m) is a relatively straightforward section of the Code that most publicly traded companies understand and are in compliance with. Compensation arrangements are commonly structured to allow executives to earn compensation in excess of the $1 million limit in the form of performance-based bonuses, which includes stock options. As a result, corporations subject to section 162(m) are generally entitled to deduct these performance-based bonuses.

Book-Tax Differences

Despite the fact that the IRS has ramped up efforts in the area of executive compensation in recent years, adjustments on executive and corporate returns as a result of executive compensation issues are relatively infrequent. Our examiners find relatively few indications of executive compensation non-compliance in return information they inspect and the returns they examine. This is an area where corporations can comply with the tax law without inordinate risk or expense and still manage to pay their executives handsomely.

One of the key transparency issues in corporate examinations is the differences between what corporations report to shareholders on their financial statements and what they report to the IRS for tax purposes. This is commonly called the book-tax difference.

One of the prime reasons for this difference is that the financial accounting and tax systems differ in terms of their goals; the goal of the tax system is to measure income and deductions fairly and accurately, in order to compute tax revenue; the goal of the financial accounting system is to provide financial data that are comparable between companies for the users of financial statements.

For financial accounting (book) purposes, beginning in 2005, stock options for most companies are valued as of the date of grant and that value is recognized as compensation expense over the period of services to which the grant relates. The valuation methods used to estimate the value of such stock options generally involve sophisticated mathematical models that estimate the expected economic outcome under the stock option utilizing numerous assumptions based on historical and other data.

This methodology reflects an important goal of financial accounting, which in this case is to match compensation expense to the appropriate period using a consistent method in order to yield results that facilitate comparison of different companies by users of financial statements.

In contrast, the primary goal of the tax system in this context is to accurately and efficiently measure compensation income and associated deductions to facilitate the collection of tax revenue. Accordingly, for tax purposes, compensation income of the employee exercising non-qualified stock options and the employer's corresponding deduction are measured based on the excess of the fair market value of the stock received by the employee upon exercise of the stock option, over the strike price. This method of measuring income for tax purposes provides an efficient and accurate measure for determining income and deductions with no prediction or estimate.

Reconciling the Book-Tax Differences

Public corporations with assets of over $10 million must file a schedule M-3 with the IRS that assists us with reconciling the differences between book and tax income. The M-3 is important to our enforcement efforts in that it provides greater transparency over the specific basis for the differences between financial statement income and expense and tax income and expense.

We use the M-3 to guide examiners to potential areas of non-compliance. Our examiners are instructed to pay attention to items on corporate schedules M-3 that are large, unusual or questionable.

The M-3 does not necessarily identify non-compliance, but it does give us an indication of areas that merit further analysis. For example, lines 2b and c ask the question: "Has the corporation's income statement been restated for the current year or any of the five income statement periods preceding?" If the corporation answers yes, it may prompt an examiner to raise additional questions and could lead potentially to the discovery that stock options have been backdated.

Stock option expense is one of the line items prescribed on Schedule M-3. Financial Accounting Standard (FAS) 123R requires recognition in financial statements of a measure of expense associated with payment for employee services with employer stock options. That measure of expense is based in part on stock value at grant date. For tax purposes the option becomes taxable at the exercise date.

Prior to the adoption of FAS 123R, companies were not usually required to recognize any stock option expense in financial statements. Thus, for companies that had not adopted FAS 123R prior to the tax years included in the 2004 aggregate Schedule M-3 data, all differences between book and tax income would have been permanent differences. Generally, for years after companies adopt FAS 123R, the differences between the book expense and the tax deduction for stock options are temporary in nature since the tax deduction comes at only one point in time, date of exercise, while the book expense is reported over time, according to a formula. Generally, public companies had to adopt FAS 123R for the first quarterly or annual reporting period that began the first fiscal year beginning after after June 15, 2005.

Latest Numbers

For Tax Year (TY) 2004, the IRS received M-3 Schedules from 31,298 companies. Of this total 3,203 identified a book-tax difference involving employee stock options. Of this total, just over 70 percent (2,278) were companies filing 10-Ks with the SEC. This represents approximately 51 percent of all companies that filed Schedule M-3 and 10-Ks for TY 2004.

For all the companies filing TY 2004 M-3s and reporting book-tax differences relating to stock options, the ***gross*** amount of book-tax difference by which taxable income was decreased was $47 billion. However, that amount does not include a $4 billion offset by companies that had begun expensing stock options in their books earlier than required by FAS 123R. So, the ***net*** amount of book-tax difference for stock options by which taxable income was decreased for TY 2004 was $43 billion.

Of the TY 2004 $43 billion net book-tax difference reducing taxable income, $40 billion was reported by 2,278 companies that also file 10-Ks with the SEC, while $3 billion was reported by companies that do not file 10-Ks with the SEC. Of this $43 billion net book-tax difference, nearly $20 billion, or 45 percent, involved the top 50 companies ranked by size of their stock option book-tax differences, that filed a 10K and which had book-tax differences related to options. Approximately $35 billion or 82 percent of the book-tax differences reported by all companies for stock options were reported by the top 250 companies.

In the 2004 aggregate Schedule M-3 data, book-tax difference related to stock option expense was the third largest book-tax difference. Only depreciation and the amount of book-tax differences related to Reportable Transactions were higher.

It is important to understand that stock options fluctuate in absolute and relative size from year to year because optionees exercise options when they perceive values are relatively high and do not exercise them when they perceive values are relatively low. The fact that stock option deductions are large does not necessarily indicate that there is anything amiss with the deductions. Since 2004 is the only year at this point for which we have aggregate Schedule M-3 data, it cannot be stated whether stock option deductions and book-tax differences for 2004 are generally high or low compared to other years. We would expect, however, that the differences between book expense and tax deductions related to stock options will more than likely decrease in total in any future years, and that the differences will be more temporary in nature due to the mandate to account for stock options in financial statements in accordance with FAS 123R.

We expect to have data for TY 2005 later this summer.

Tax Evasion or Avoidance

As I mentioned earlier, despite our ramped up efforts in the executive compensation arena, adjustments on executive and corporate returns as a result of executive compensation issues are still relatively infrequent in that compliance is relatively simple. One of the areas where we have spent considerable time in the past year has been on the backdating of stock options.

In general, corporate stock options are granted to employees with an exercise price equal to the market price of the stock on the date of grant. An employee benefits from an option if the market price of the stock on the day the option is exercised exceeds this exercise price. The practice of backdating options allows the use of hindsight to pick a date for the exercise price on which the market price was lower. By using the lower stock price the employee has increased realized gain on the option and makes it possible for the employee to benefit from corporate performance that occurred before the option was granted. While this practice does not guarantee income upon exercise, it increases the value of the option and makes it more likely the employee will be able to exercise the option at a time when the market price exceeds the exercise price (i.e., at a time when the option is "in the money").

As this simplified description of the practice suggests, backdated options that are in the money do not measure the performance of the company from the date of grant, and as a consequence, they may not be treated as performance-based compensation under section 162(m). Thus, for the company, the tax implications are that any deduction of compensation related to the backdated option would be subject to the $1 million limitation of section 162(m).

In addition, if an Incentive Stock Option (ISO) is backdated, the option will no longer qualify for preferential ISO treatment and will be reclassified as a nonqualified stock option. The difference between the exercise price and the sales price would be additional wages to the executive and must be included on the employee's Form W-2 in the year of exercise. The executive will lose favorable capital-gain treatment and may be subject to alternative minimum tax as the result of the exercise. The corporation may be eligible for an additional wage deduction if the section 162(m) limitations are not triggered.

Internal Revenue Code §409A impacts virtually all companies that have nonqualified deferred compensation plans. Companies will need to revise their executive compensation arrangements to avoid the considerable penalties imposed for not complying with the strict new rules passed by Congress and signed into law in October 2004.

IRC Section 409A requires immediate inclusion of income and imposes an additional 20 percent tax and interest on the tax that would have been paid if the deferral amount had been taxable when first deferred if specified requirements for nonqualified deferred compensation are not met. A stock option having an exercise price that is less than the fair market value of the stock on the grant date constitutes deferred compensation for purposes of Section 409A. Section 409A applies to options granted after 2004 and options granted before 2005 that were not earned and vested as of December 31, 2004.

To provide relief to rank-and-file employees, the IRS issued legal guidance, Announcement 2007-18, which announced a compliance resolution program to allow employers to pay additional taxes generated by the exercise of certain discounted stock options and related appreciation rights in 2006 for their employees. The announcement was issued on February 8, 2007. The deadline for requesting relief under Announcement 2007-18 and the employer's intent to participate in the Program closed on February 28, 2007. Relief will be granted to 80 employers and over 13,500 employees upon completion of the requirements. The Program required the 80 employers to compute and pay the additional taxes and interest, associated with the exercised stock options, owed by these employees by June 30, 2007. As of May 30, 2007, the IRS has processed over $78.7 million dollars of payments from the employers. This represents no compromise on the actual tax liability incurred but merely allows employers to satisfy the obligations of affected employees.

In the past year, the IRS's focus on backdated stock options has intensified. Backdated Stock Options (BSO) issues receive the highest priority within the IRS' Large & Mid-Sized Business (LMSB) operating division. Currently, LMSB has identified over 180 companies with confirmed or potential backdating.

Company identification is accomplished through company press releases, SEC filings, and the normal audit process. The IRS has also identified a number of companies through its administration of the Compliance Resolution Program, which provided relief for rank and file employees who exercised "discounted options" and were not considered corporate "insiders."

We have also completed examinations in a number of cases under Notice 2003-47. This was a settlement initiative for executives and companies that participated in an abusive tax avoidance transaction involving the transfer of stock options or restricted stock to family controlled entities.

Under this scheme, executives, often facilitated by their corporate employers, transferred stock options to family controlled partnerships and other related entities typically created for the sole purpose of receiving the options and avoiding taxes on compensation income normally taxed to the executive. The tax objective was to avoid payment of income and employment taxes. In many cases the corporation deferred a legitimate deduction.

Thus far we have completed 156 examinations and assessed taxes, penalties and interest totaling over $211 million. This includes both taxpayers that elected to participate in the settlement initiative and those that did not. There are also 16 Notice 2003-47 cases that have not been resolved and are currently under examination by LMSB, 3 corporations and 13 individuals.

Additionally, the IRS' Small Business Self-Employed Division has established the Broker Initiative Project. One purpose of this project is to detect transfers of options to entities domiciled in offshore secrecy jurisdictions that are beneficially owned by U.S. persons. The examinations have not been underway long enough and have not involved enough brokerage firms to draw conclusions as to the extent to which stock options have been used to avoid or evade federal taxes.

Summary

Abuses in the areas of executive compensation are a concern from a tax administration perspective. IRS will continue to prioritize its efforts in the entire area of executive compensation. However, as I indicated, this is an area where we, in many instances, are unlikely to identify significant noncompliance through our traditional corporate audits.

Greater transparency will certainly assist us in identifying potential noncompliance in an area such as the granting of stock options. Our analysis of the schedule M-3 for TY 2005 should provide some additional information in this area in that most companies should be in compliance with FAS 123R.

But, based on what we have seen thus far, it is not that difficult for companies to compensate senior executives at whatever level they choose and remain fully compliant with the tax laws.

I appreciate the opportunity to be here this morning, and I look forward to any questions.

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

John W. White
Director, Division of Corporation Finance
U.S. Securities and Exchange Commission

Before the U.S. Senate Permanent Subcommittee on Investigations

June 5, 2007

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 *See 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).

Testimony of Lynn Turner

I want to thank Chairman Levin, Ranking Member Coleman, and Members of the Subcommittee for holding this hearing on an issue that I believe is certainly of interest to both American taxpayers and investors.

I currently serve as a member of the board of a public technology company and trustee of a mutual fund. I have also had the pleasure of serving as a chief financial officer of an international company that employed the use of stock options, as an employee and audit partner of a major international accounting firm that prepared corporate income tax returns, as a former member of the Securities and Exchange Commission (SEC) staff, as an accounting professor, and as a managing director of research for a proxy governance and financial research firm that advises institutional investors with over $10 trillion in assets under management.

The issue of executive compensation has been one that has attracted much interest, regardless of the perspective from which observed. Analyzing compensation, and its key components including equity awards, has been critical from a corporate governance and investing perspective, as well as from the role of management. Ensuring that pay is properly aligned with performance and transparency is provided to investors is a key component of good corporate governance.

However, in the past decade, newspapers have heralded excesses in compensation at many a public company. Indeed, as the new SEC disclosure rules went into effect for the 2007 proxy season, investors learned there has been a lack of transparency with respect to compensation, including the impact of options. Unfortunately, last minute changes the SEC made to the disclosure rules in December of 2006, detracted somewhat from the transparency that might have been achieved.

Abusive Stock Option Practices

Likewise in recent decisions of the Delaware court of Chancery, the court took strong exception to the improper granting of stock options and lack of transparency surrounding that process.[1] This is especially disturbing given that over 250 public companies have

[1] See in the matter of Ryan vs. Giffor, Civil Action No. 2213-N, February 6, 2007 in which the court stated: "The plans do not grant the board discretion to alter the exercise price by falsifying the date on which options were granted. Thus, the alleged facts suggest that the director defendants violated an express provision of two option plans and exceeded the shareholders' grant of express authority." Also see in the matter of Tyson Foods Consolidate Shareholder Litigation, Consolidated C.A. No. 1106-N, February 6, 2007, in which the court stated: "Whether a board of directors may in good faith grant spring-loaded options is a somewhat more difficult question than that posed by options backdating, a practice that has attracted much journalistic, prosecutorial, and judicial thinking of late.74 At their heart, all backdated options involve a fundamental, incontrovertible lie: directors who approve an option dissemble as to the date on which the grant was actually made. Allegations of spring-loading implicate a much more subtle deception.75 ...Granting spring-loaded options, without explicit authorization from shareholders, clearly involves an indirect deception...A director who intentionally uses inside knowledge not available to

acknowledged they have had to undertake investigations of backdating and/or spring-loading of options. And as the Senate hearings in September of last year noted, these improper and illegal practices certainly can have an associated income tax consequence. Unfortunately, to date, and over two years after the SEC became aware of such practices, the SEC has failed to bring but a handful of cases against those responsible for engaging in such behavior.

We can only hope that those who have acted outside of the law will be held accountable in the future, by law enforcement agencies. Academic research has suggested that over 13 percent of stock option grants from January 1, 1996 to December 1, 2005 were backdated or manipulated.[2] Accordingly, it appears that many companies have not disclosed to their shareholders past practices of manipulating the grants of stock options.

In the past, many argued that stock options aligned the interests of stockholders and employees. However, that proved to only be a partial truth. For example, after the bursting of the stock market bubble in 2000 and 2001, we quickly learned that employees holding stock options do not share in losses incurred when there are market downturns.

We have also seen other abuses of stock options. For example, when the stock markets declined with corresponding declines in stock values, it has not been uncommon for management and/or boards of directors to reprice stock options, lowering the price at which they can be exercised, thereby cushioning the blow from market declines for executives and employees. In essence, management was given a "mulligan," while shareholders were not afforded the same type of economic benefits.

Likewise, in recent years, we have seen over 1,000 public companies accelerate the date on which options are considered vested. This was often done when companies were faced with implementing the new accounting standards requiring expensing of stock options. And while some argued there was no benefit provided to employees, a recent study found that over $400 million of intrinsic value was realizable by employees of just 49 companies that accelerated the vesting of their options.[3]

Even the new accounting standard requiring the expensing of stock options has seen efforts to circumvent its principal objective of requiring the fair value of the option grant to be expensed. Perhaps that should be no surprise given that many, including certain members of Congress, opposed such transparent reporting to investors. But the world did not come to an end when such accounting was mandated. However, for some, it may have also brought on a practice of engaging in number management.

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shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary."

[2] What fraction of stock option grants to top executives have been backdated or manipulated? Randall A. Heron, Erik Lie. July 14, 2006.

[3] Options Closed: The End of "Accelerated Vesting". The Analyst's Accounting Observer, Jack T. Ciesielski. August 15, 2006.

One of the easiest and most powerful ways to reduce the amount of expense one has to report for the value of options is to reduce the volatility factor that is used to compute the value. Note that when volatility goes down, the corresponding expense reported for a stock option grant will also decline. Consistent with that notion;

> "Median volatility assumptions in 747 Russell 2000 companies started declining in 2003 and has decreased each year since then. Similarly, median volatility assumptions in 310 S&P 500 companies started declining in 2004 and also decreased in 2005. Median volatility assumptions in both indexes were little changed in the three prior years. The beginnings of those declines were coincidental with events signaling the coming of stock option expense treatment – the issuance of two exposure drafts dealing with the subject. The change in the volatility assumptions was broad-based; in those periods of declining assumptions, a wide majority of firms in each index notched down their assumptions.
>
> Volatility assumption declines were especially broad-based in 2005. In the Russell 2000 during 2005, there were 894 companies out of 1,366 (having sufficient data) that decreased their volatility from the previous year – 65% of the total. In the S&P 500, there were 327 firms decreasing their assumptions out of 406 possible firms – over 80%. The median assumptions in both indexes declined 4% between 2004 and 2005."[4]

Accordingly, it appears some companies are either using questionable if not improper assumptions for purposes of calculating their stock option expense to be reported in their financial statements. This includes the use of option pricing models which have been properly challenged by the Council for Institutional Investors and its members.

Back to the issue of stock options and compensation, as a former regulator and chief accountant for the SEC, the biggest concern I have with respect to the granting of options, is the correlation academic research has shown between the use of options and fraud. For example, one academic study found that "...CEO's of fraud firms have greater option-based compensation than their control firms...We interpret our findings as being consistent with the view that there is a "dark side" to incentive compensation."[5] Authors of another study found "...that three factors increase a firm's probability of misrepresenting its financial position: performance below its industry's average performance, performance significantly above its own past performance, and its CEO receiving a high proportions total compensation as stock options."[6] Accordingly, it appears and I certainly believe, that stock options when not properly utilized, can serve as an addictive drug for executives, leading them to engage in unlawful behavior. Perhaps

[4] Employee Stock Option Volatillity Assumptions; Real or Not? The Analyst's Accounting Observer, Jack T. Ciesielski. October 12, 2006.
[5] Is there a Dark Side to Incentive Compensation? David J. Denis, Paul Hanouna, Atulya Sarin. March 2005.
[6] Incentives to Cheat: The Influence of Executive Compensation and firm performance on Financial Misrepresentations - Abstract. Jared Harris, Philip Bromiley. March 2005.

that is why some well known individuals such as former Federal Reserve Chairman Paul Volcker have recommended against the use of stock options.

Remedies for Stock Option Abuses

In order to help foster good corporate governance and management, lawful behavior, and greater transparency for investors, I believe certain changes could be adopted that would help in a meaningful way to avoid the type of abuses and illegal behavior noted above.

As a former business executive and partner in a major international accounting firm, I have seen upfront how income tax laws and regulations do affect business decisions – sometimes in a negative fashion. It should be no surprise that my experience has shown management often tries to maximize both the amount and timing of expense deductions for income tax purposes, while minimizing them for purposes of financial reporting to investors. It is simply a matter of minimizing net income for tax purposes, and maximizing net income reported to investors.

Income tax deductions can have a very significant impact on the cash flow of any company and so it behooves management to maximize them. And of course, the analysis of any stock option program is going to include the impact of the cost on a net basis, after factoring in any benefits from income tax deductions. As such, these tax implications also provide a strong incentive for management to see how close to the "line" they can get when preparing their income tax returns and encourage taking of aggressive income tax positions. This is especially true for public companies. And as we have seen with recent corporate scandals, some seem blinded to when they are getting close to the line as opposed to going over it.

As a result, I would strongly recommend the creation of tax legislation and regulations that would foster a consistent calculation of the amount of the deduction for the fair value of options for both financial reporting and income tax purposes. I firmly believe there is an economic cost to the issuance of options. That cost should not vary simply because it is reported to the Internal Revenue Service on a Form 1120 as opposed to investors on a Form 10-K. Unfortunately, current income tax regulations have created incentives that have led to the abuses noted earlier and should be considered for appropriate modifications.[7]

Such legislation would create a very positive incentive for companies to stop manipulating and minimizing the amount of expense they report to investors. Rather, it

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[7] Commission on Public Trust and Private Enterprise. The Conference Board Inc. 2003. The report of the Commission states: "It rejects the kind of solutions which resulted from legislation enacting Section 162(m) of the Internal Revenue Code (which limited the tax deductibility of cash compensation over $1 million). Stock options qualify for an exemption under Section 162(m) since they are largely considered to be performance-based compensation. Therefore, Section 162(m), especially combined with the favorable accounting treatment for stock options under current accounting principles, contributed to fixed-price stock options becoming the dominant form of executive compensation."

would result in a more balanced approach in which both transparency for investors and income tax considerations would be balanced. In essence, a desire to report higher earnings to investors by manipulating the amount of stock option expense downward, would be appropriately balanced by the desire to maximize income tax deductions, and in doing so, maximizing cash flows.

Legislation giving shareholders an advisory vote on compensation, such as that recently passed in the House should also be adopted. Many foreign countries such as the United Kingdom, the Netherlands, and Australia have adopted such legislation and policies as a matter of good corporate governance. Such policies have also become a very important and integral part of the regulatory scheme in those countries. More importantly, a shareholder advisory vote provides the owners of the business with an opportunity for meaningful input and dialogue on compensation when the boards of directors and management fail in their fiduciary obligations.

I believe active and appropriate oversight by the SEC of reporting of executive compensation is needed as well. Actions taken to date indicate that many responsible for the option backdating scandal will either never be known, or will avoid accountability for behavior outside the law. Neither of these should be permitted to occur. Likewise, the use of models to fair value options that are intended simply to minimize and manipulate the value of stock options should be more closely examined by the SEC and prohibited.

This concludes my remarks and I would be happy to answer any questions the committee might have.

Testimony
of
Mihir A. Desai
Associate Professor
Harvard University

before the
Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs
U.S. Senate

June 5, 2007
9:00 a.m.

Chairman Levin and members of the Subcommittee, it is a pleasure to appear before you today to discuss the accounting and tax treatment of incentive compensation. I am an Associate Professor of Finance at Harvard Business School and a Faculty Research Fellow of the National Bureau of Economic Research.

My comments below provide an overview of the financial and tax accounting systems and their treatment of incentive compensation. Independently, the topics of financial accounting, tax accounting and stock options are extremely confusing. Taken together, they can be overwhelming and, frankly, mind-numbing. While my comments below are much more nuanced, I thought I would begin with a thought experiment that I've found helpful for simplifying the relevant issues.

Imagine if you were allowed to represent your income to the IRS on your 1040 in one way and on your credit application to your mortgage lender in another way. In a moment of weakness, you might account for your income favorably to your prospective lender and not so favorably to the IRS. You might find yourself coming up with all kinds of curious rationalizations for why something is an expense for the tax authorities but not an expense to the lender. You don't have this opportunity and for good reason. Your lender can rely on the 1040 they review when deciding whether you are credit-worthy because you would not overly inflate your earnings given your desire to minimize taxes. Similarly, tax authorities can rely on the use of the 1040 for other purposes to limit the degree of income understatement given your need for capital. The uniformity with which you are forced to characterize your economic situation provides a natural limit on opportunistic behavior.

While individuals are not faced with this perplexing choice of how to characterize their income depending on the audience, corporations do find themselves in this curious situation. A dual reporting system is standard in corporate America and, judging from recent analysis, gives rise to opportunistic behavior.

Indeed, a significant cost for corporations – the cost associated with compensating key employees with stock options – was until recently treated as an expense for tax purposes but not for financial accounting purposes. More specifically, the value of stock options exercised in a given period gave rise to a taxable deduction for corporations while those stock options were never expensed for financial accounting purposes, though they were noted in other disclosures. This can be viewed as the most advantageous way to treat an expense – reducing the firm's tax liability while not detracting at all from its financial bottom line.

Recent changes in financial accounting have changed this asymmetry so that there is now an expense associated with stock options but a considerable difference still exists with tax rules. Specifically, the *amount* and *timing* of the deduction are distinctive. The financial accounting expense is at the time of grant and the amount expensed is the value of the options at the time of grant (versus the value of the exercised options at the time of exercise). Grant and exercise values, as well as their timing, will differ significantly. Historically, the distinctive treatment of stock options has contributed significantly to the overall difference between financial and tax accounting reports, as shown in Desai (2003) and Boynton, DeFilippes, and Legel (2006).

Does this situation make sense? In order to consider this question, I review the nature of the dual reporting system in the U.S., the debate over changing this system to one where conformity would be more common, thc international experience with increased conformity, evidence on the behavioral consequences of stock options, and international variation on the tax treatment on stock options. Several conclusions emcrge:

1. As suggested by the example above and further elaborated on below, the dual reporting system can enable opportunistic behavior by managers at the expense of investors and tax authorities. This insight, from an emerging body of work labeled the "corporate governance view of taxation," suggests that tax authorities can be meaningful monitors that complement the activities of shareholders concerned with opportunistic insiders. Under the current dual reporting system, it is impossible for investors to tell what firms pay in taxes, clouding what a firm's true economic performance is. The evolution of the two parallel universes of financial and accounting reporting systems appears to be a historical accident rather than a manifestation of two competing views of what profits should be. Aligning tax definitions with financial accounting standards can have payoffs to investors and tax authorities, can lower compliance costs of the corporate tax, and allow for a lower corporate tax rate on a wider base. Concerns over greater alignment between tax and financial accounting are important but many of these concerns are overstated, as I discuss below.

2. Changing financial accounting standards has stimulated debate worldwide on the virtues of greater conformity. Many countries, including notably the U.K., have shifted toward greater alignment of tax and accounting reports with little apparent disruption. More broadly, tax authorities in many countries in the European Union explicitly reference financial accounting treatments in several parts of the tax treatment of corporations. Indecd, the European Union is contemplating yet a more aggressive alignment between tax and accounting rules. The relative segregation of financial accounting and tax treatment of corporate income appears to make the U.S. somewhat anomalous by international standards. By itself, this international experience is informative but hardly decisive as the U.S. may choose quite different rules for good reasons. Nonetheless, it is enlightening to see that increased conformity can work and need not represent a doomsday outcome as some have suggested.

3. Stock options are a critical part of our economic system today. They are extremely valuable tools that have numerous benefits and several costs. Their use is influenced by their accounting treatment and, to some degree, to their tax treatment. As such, changing the accounting and tax treatments of stock options can be expected to change their use. Existing evidence, though

scant, is consistent with increased disclosure limiting the use of stock options but also with investors appreciating the disclosure and changing their valuations of firms accordingly.

4. There exists considerable variation internationally on the tax treatment of stock options. In particular, some countries, such as Canada, do not allow any tax deduction for stock options while others take the deduction at the time of grant and others follow the U.S. and provide a deduction at the time of exercise. Again, this international experience is informative but hardly conclusive as the U.S. may choose quite different rules given that stock option compensation is much more central to compensation in the U.S. than elsewhere. Nonetheless, it is enlightening to realize that there are many different ways to solve this problem and that the current situation is not a natural solution.

5. Bringing the tax treatment of stock options into alignment with the recent changes to the accounting treatment has a number of virtues. First, it would make the tax treatment consistent with the accounting profession's well-reasoned analysis of when this deduction is appropriate and what the right amount of the deduction is. Second, as with other movements toward greater alignment, reducing the reporting distinction in how managers are paid can create greater accountability and reduce distortions to the form of managerial compensation. Third, there is limited reason to believe that the purported costs typically attributed to greater alignment between tax and financial accounting would be relevant in this setting. There are a number of nontrivial complications associated with such a change. Implementing such a change will require thinking through if the timing of taxable events for individuals and corporations can be separated and if the compensation expensed by corporations and earned by individuals need be the same.

In sum, this example of increased conformity between financial and tax accounting has much to recommend it and need not be viewed as a radical departure from global practice. It will still allow for the many benefits of incentive compensation to accrue to the U.S. economy without continuing the distortions associated with the current anomalous distinction between tax and accounting reports.

I begin by elaborating on the nature of the "dual reporting system" and what we have learned about how it functions. A variety of studies and the international experience suggest that revisiting the foundations of the information environment for firms is overdue. Having established the contours of the debate over the dual reporting system, I then want to provide some perspective on incentive compensation and its accounting and tax treatment. In particular, I will discuss the importance of incentive compensation to the American economy, the difficulties it can create, and how the tax and accounting treatment of options influence their use. I conclude with some specific thoughts on how greater conformity of the treatment of options expensing could be implemented and what problems it would solve.

It should be noted that when "conformity" or "greater conformity" is referred to below, it is meant to describe the use of financial accounting definitions as a *default* measure of income for tax authorities with *select* departures for specific tax policy goals. It is not meant to describe the use of tax accounting definitions for financial reporting purposes nor is it meant to describe a system where financial accounting definitions are adopted wholesale without modification. In many places below, I refer to "alignment" rather than "conformity." I believe that the term alignment is more descriptively accurate as the term conformity implies a great deal of rigidity.

I. The Dual Reporting System

The last decade has featured two seemingly contradictory concerns related to corporate profits. First, corporate scandals have focused attention on efforts by managers to artificially inflate profits reported to capital markets. Second, tax authorities have focused increased attention on the activities of firms to depress profits to pay lower taxes. How could both these concerns be operative simultaneously? The answer is the dual reporting system. In this section, I begin by describing how this system works and why defenders support it. I continue by revisiting what we have learned about the dual reporting system over the last decade and the virtues and concerns related to adopting greater conformity.

I.A. How does dual reporting work?[1]

American firms keep two sets of financial statements: a financial statement that reports "book profits" to the capital markets and a separate financial statement that reports "tax profits" to the government. These two profit reports can bear little resemblance to each other and follow distinct rules. One such example of this distinction is the treatment of incentive compensation in the reports of profits to capital markets and tax authorities.

Conceptually, the many differences between book and tax profits largely center on differing treatments associated with the *timing* and *location* of income. With respect to timing, accountants have developed a variety of rules to ensure that income is measured when earned and associated expenses are incurred in parallel, through the system of accrual accounting. In contrast, tax authorities emphasize the actual receipt of proceeds and the actual payment of expenses. In a related vein, book profits reflect subjective, probabilistic assessments of expenses, such as contingent liabilities, while tax authorities are reluctant to provide deductions for anything but actual payments.

With respect to location, book profits measure the worldwide income of firms, which is increasingly comprised of earnings from overseas operations. In contrast, the international tax regime for U.S. multinationals considers the repatriation of earnings to the U.S. to be the recognition event for tax purposes. As a consequence, profit reports differ given the differing definitions of worldwide income. More generally with respect to location, the rules differ markedly with respect to entity definition and consolidation rules creating myriad differences in how a tax entity is defined relative to an accounting entity.

The dual reporting system is also accompanied by asymmetric sharing of information on profit reports. Tax authorities have access to reports to capital markets while investors cannot access confidential tax returns. The confidentiality of tax returns, which prevents explicit comparisons of the two profit reports by capital market participants, is usually defended on the grounds that competitors could glean useful information from tax returns.

I.B. Why do we have dual reporting?

Supporters of the dual reporting system rely on the intuition that the two books serve two distinct purposes. The Supreme Court decision usually cited, Thor Power Tool Co. v. Commissioner (439 U.S. 522 [1979]), states that:

> The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income

[1] This section draws on Desai (2005).

> tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistent with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

This intuition that two different functions are being served by the two reports continues to be the primary argument for sustaining dual reporting.

Defenders of the current dual reporting system also tend to emphasize that reconciliation of the two profit reports is possible in two ways. First, the accounting standards that guide reporting of tax expenses on public financial reports are meant to provide sufficient information to infer a firm's tax position. While income statements typically keep tax information to a minimum, more detailed footnotes provided in public registration statements are meant to provide further information on the nature of a firm's tax position. Second, corporations must explicitly reconcile book profits and tax profits on their tax returns. This reconciliation, which begins with aggregate book profits and is designed to categorize the discrepancies with tax profits, is part of a corporation's returns and, as such, is only available to tax authorities.

I. C. What have we learned about the dual reporting system?

The debate on the merits of the dual reporting system has been somewhat heated.[2] As such, it is useful to begin with the relatively unambiguous conclusions that have emerged from recent work on the dual reporting system.

1. Public financial reports tell us little or nothing about what a firm pays in taxes.

As discussed above, proponents of the current system suggest that information about taxes paid is available to investors so it is not clear that increased conformity would serve a meaningful purpose. Indeed, given that thirty-five cents of every pretax dollar is supposed to go the government, one would think that such a large cost figure would be easily deduced or that it would be clearly reported. In fact, research has shown that the amount corporations pay in taxes is impossible to decipher from annual reports. Leading accounting scholars have reviewed the intricacies of tax footnotes of leading companies and cannot answer a simple question: how much did this company pay in taxes? Specifically, Hanlon (2003) reviews the tax footnotes of several major corporations and demonstrates that several contradictory conclusions regarding their tax positions, depending on the information used, are entirely feasible.[3]

2. The argument that tax and financial reporting have different purposes is a new argument.

[2] Critics of increased conformity have labeled it a "naïve proposal" with "dangerous" consequences. For a particularly eloquent statement for maintaining the *status quo*, see Shackelford (2006).

[3] Large sample evidence that compares tax returns to public financial statements yields a contradictory set of conclusions on the degree to which public financial statements, on average, can yield meaningful information on tax payments (Graham and Mills, 2007; Plesko, 2006). Recent reforms in tax reporting, as advanced in Mills and Plesko (2003), have led to an increased ability to match public financial statements to tax returns for tax authorities without any increased access to this information for shareholders.

The 1979 Thor decision has led various supporters of the *status quo* to assert that financial and tax reporters serve two distinct purposes and should therefore not be conformed. Revisiting the history of the corporate income tax clarifies that this view is a decidedly modern notion and also reveals just how curious the current state of affairs is. With respect to the measurement of income, accountants, economists, and firms all argued at the onset of the corporate tax that accounting income should be employed for assessing tax burdens. When the income tax was first devised, Robert Haig, the Columbia University economist who helped devise the Haig-Simons definition of income, stated that "it goes without saying that taxable income under an income tax law should approximate as nearly as practicable the true net income as defined by the analysis of the economist and the accountant." (Haig, 1921) Indeed, accountants and firms vigorously argued that accounting income was the only correct basis for taxing corporate profits arguing that differing definitions would require "duplicating the present cost of the accounting department, serving no useful purpose whatever" (quoted in Robinson, 1911). Through the middle of the last century, firms continued to argue for greater conformity toward accounting standards given the costs of dual reporting.

A historical review of the motivations for the corporate tax also makes clear that the sponsors viewed the tax as advancing the efforts to control corporations through dissemination of additional information of their activities. As contemporaneously profiled by Robinson (1911), the corporate income tax should not "be judged primarily upon its capacity to produce revenue or to distribute the fiscal burdens equitably. Its important function in the view of its sponsors was to give publicity and to furnish the basis of government supervision of corporations." This intuition for the intent of the tax seems to accord well with the idea that a corporate income tax should be viewed as part and parcel of the system of monitoring corporate activity for various corporate shareholders, a goal presumably impeded by the maintenance of a confidential, distinct set of profit reports.

Up through the middle of the last century, many firms continued to argue for greater conformity between tax profits and accounting standards, given the costs of dual reporting. But over time, as Knott and Rosenfeld (2003) describe it, the two accounting systems have evolved into "parallel universes" with innumerable differences in treatment. The evolution of two distinct accounting systems is largely the story of the refinement of accounting science in addressing issues like the timing and location of income, combined with stagnation in the ways in which tax authorities measure income. In contrast to their historical positions, firms and accountants now generally argue against conformity between the two sets of accounts and disclosure of corporate tax returns. Given the costs involved in maintaining two books, firms presumably have come to value the opportunity to characterize their profits in distinct ways to the capital markets and tax authorities.

3. In the aggregate, deviations between profit reports to tax authorities and capital markets have become large and difficult to understand

Over the last decade, the connection between aggregate financial accounting income and tax income has become more tenuous. A variety of commentators have tried to reconcile the two values, in aggregate, with limited success based on accepted differences between the two profit reports. Estimates of the overall difference for the years prior to the advent of the M-3 reconciliation form were as high as $150 billion annually with differences arising from stock options constituting a significant fraction of that amount.[4]

Thanks to the implementation of the M-3 reconciliation form, as advanced in Mills and Plesko (2003), it is possible for researchers with access to this confidential data to tell us more about this gap. More recent analysis using this data, as in Boynton, DeFilippes, and Legel (2006) and Weiner (2007) confirms many of the finding from previous studies. The distinction continues to be large (on the order of $140 billion) and stock options constitute a sizable fraction of that gap for 2004, the first year for which M-3 data is available.

The M-3 has been very useful for providing a broad characterization of the differences between the two profit reports. It is worth noting that the usefulness of the M-3 has been limited by its confidential nature. Data are accessible only to researchers granted explicit access, and then only with a lag of several years. And, obviously, investors cannot access information about their specific firms. Moreover, the fundamental differences between the two reporting systems remain large and permit a decomposition of the overall gap only into broad categories.

I. D. The case for greater conformity

Part of the argument for greater conformity rests on the three fairly uncontroversial facts above. First, investors should be able to infer what a firm pays in taxes and the dual reporting system currently does not permit that. Second, investors and the government have a common interest in understanding what economic profits are and there is no reason to have two systems as there is a common goal. Finally, the large deviations that have arisen between the profits reported to capital markets and tax authorities are confusing and cloud the interpretation of corporate profits at the aggregate and corporate level.

While these facts relate to the difficulties created by the dual book system, there are also potential distinct advantages associated with adopting a greater degree of conformity. The latter two advantages described below – lower compliance costs and a potential lower tax rate on a broader base – are fairly straightforward. The other primary advantage associated with greater conformity is that greater conformity would limit opportunistic behavior by managers by taking away a margin of discretion that they appear to use opportunistically. In order to understand this advantage, it is important to take a detour through an emerging theory of how taxation and corporate governance interact. At the end of this brief subsection on corporate governance and taxation, I return to the implications of this view for the debate on whether greater alignment between tax and financial accounting makes sense.

1. The corporate governance view of taxation[5]

The basic intuition for how corporate governance and taxation interact builds on the realization that shareholders and tax authorities are both residual claimants on a firm's pretax cash flows. In essence, the state becomes the largest minority shareholder in every corporation through the corporate tax. Both shareholders and the state are worried about insiders (either managers or other large shareholders) not sharing those pretax cash flows appropriately, giving rise to a common interest between the tax authorities and shareholders. For example, efforts to undertake tax avoidance demand complexity and obfuscation to prevent detection by tax authorities. These characteristics, in turn however, can become a shield for managerial

[4] See, for example, Desai (2003) and Hanlon and Shevlin (2002, 2005).
[5] This section draws on Desai and Dharmapala (2007).

opportunism whereby shareholders are also made worse off. So, tax avoidance can give rise to managerial opportunism that then creates losses for both tax authorities and shareholders.[6]

This view can be thought of as, narrowly, an "agency perspective on tax avoidance" or, more broadly, as the "corporate governance view of taxation." In order to consider the relevance of this model, it is useful to provide some real-world illustrations of these interactions.[7] Initially attracted by the tax benefits of a shelter, Dynegy (an energy company) gave up plans to undertake the shelter when a journalist reported on the proliferation of such transactions. Their appetite for the shelter reappeared as investors began to question the quality of Dynegy's earnings. As a result of these pressures, managers began looking for devices to meet earnings and cash flow targets. Ultimately, they structured the tax shelter transaction so that it provided operating cash flows on Dynegy's financial statements. Indeed, the transaction size was determined by the amount of proceeds that would allow for a $300 million increase in operating cash flow and a 12 percent rise in net income. When the financial accounting treatment was in jeopardy, several Dynegy officials began maintaining two sets of documents in order to ensure that the transaction could close. Ultimately, several Dynegy employees admitted to federal fraud and conspiracy charges related to disguising a loan as operating cash flow, and one employee was convicted of those charges (Desai and Dharmapala, 2006a).

This brief summary of the Dynegy example provides some intuition for how sheltering activities might give rise to opportunities for managers to pursue activities designed to mislead investors. First, a tax-oriented transaction became desirable when it morphed into a vehicle for misleading the capital markets. Second, features of the transaction designed to make it more opaque to the capital markets were justified on the basis of secrecy, supposedly necessitated by tax objectives. Finally, actions that served as the origins of the conspiracy to mislead the auditors were also justified on this same basis.

Earning manipulation was also central to Enron's extensive use of tax shelters. In summarizing various transactions, the Joint Committee on Taxation (JCT) concluded that Enron's management realized quickly that tax-motivated transactions could generate sizable

[6] More formally, the technologies of tax avoidance and managerial diversion can be thought to be complementary. That is, undertaking tax avoidance can reduce the costs of undertaking managerial diversion or, alternatively, reduce the likelihood of detection. This complementarity is modeled in Desai, Dyck, and Zingales (2007) as creating an interaction between resources diverted by managers and the amount of tax savings created by shelters. Another form of this complementarity is modeled in Desai and Dharmapala (2006a) as creating an interaction between the ability to reduce taxable income and inflate book income in a setting of dual reporting.

[7] Such examples are necessarily taken from court proceedings and thus reflect the experiences of firms caught in malfeasance. Nonetheless, the examples are illustrative of the broader phenomena, and they also point to the more widespread nature of these activities. This logic can also be understood by a hypothetical example. Suppose that managers of a firm begin creating several special purpose entities (SPEs) in tax havens. These entities are rationalized as providing the means for reducing tax obligations. The details of the structures and transactions cannot be explicated fully or widely, explains management, due to the likelihood of detection by the tax system and the revocation of those benefits. Such structures and secrecy may also allow managers the ability to engage in various activities that may be harmful to shareholders. More specifically, such entities may facilitate earnings manipulation (by creating vehicles that can manufacture earnings without enabling investors to understand their source), the concealment of obligations (by taking on debt that is not fully consolidated), or outright diversion (by allowing for insider transactions that are not reported widely). The secrecy laws of tax havens may well assist managers in obscuring these actions, all of which are rationalized as tax avoidance undertaken for the shareholders' benefit.

financial accounting benefits. Accordingly, "Enron looked to its tax department to devise transactions that increased financial accounting income. In effect, the tax department was converted into an Enron business unit, complete with annual revenue targets. The tax department, in consultation with outside experts, then designed transactions to meet or approximate the technical requirements of tax provisions with the primary purpose of manufacturing financial statement income" (JCT, 2003).

One example of such a transaction was "Project Steele." As Enron had already guaranteed that it would not pay taxes well into the future through previous tax shelters, this transaction was motivated by the fact that it would create $133 million in pretax financial accounting income. Ironically, in order to generate favorable tax treatment, Enron admitted that its "purported principal business purpose for the transaction was to generate financial accounting income" (JCT, 2003). In addition to the fact that no current tax savings were generated, it is also useful to note that the very complex structure was extremely costly. Project fees were estimated at over $11 million. As such, shareholders did not benefit from material tax savings, were manipulated by managers with financial accounting goals, and paid considerable fees in the process.

How representative is such a transaction in depicting what motivates corporate tax shelters? The documents released through the JCT's investigations reveal that the purveyors of the transaction recognized the centrality of financial accounting benefits to corporate tax shelters. Bankers Trust, the advisor to Enron on this transaction, initially showed a variant on the final structure that did not provide financial accounting benefits. Internal documents reveal that Bankers Trust concluded "that it would not receive much, if any, interest for the tax benefits alone but if the transaction were redesigned to provide for financial accounting benefits, as well, then corporate clients would be extremely interested and would pay a substantial fee. . . other less expensive alternatives exist to generate equivalent tax benefits" (JCT, 2003).

These examples illustrate how central financial accounting motivations are to undertaking tax shelters. Desai and Dharmapala (2006b) provide a more general stylized example of how earnings manipulation goals can be facilitated by tax shelters. The wider theme here is that tax shelters may provide diversionary opportunities through obfuscation that is easily rationalized as tax avoidance, as in the Sibneft example in Desai, Dyck, and Zingales (2007). These interactions between avoidance decisions and managerial misbehavior are the critical grounding of the corporate governance view of taxation.

Empirically, the corporate governance view of taxation appears to have validity. In evidence from Russia, Desai, Dyck, and Zingales (2007) show that a Putin administration's crackdown on tax evasion by corporations in 2000 led to an *increase* in market value in the firms targeted, and that the voting premia for these firms (a proxy for private benefits of control) declined. Indeed, contemporaneous accounts of the crackdown noted that tax avoiding companies "have begun closing offshore subsidiaries and consolidating their operations within Russia. To comply with the law, they have to declare higher profits and pay higher taxes. They must also show the true extent of their financial operations to outside shareholders, who are just as keen to have a share of the proceeds as the tax inspector." (Jack, 2001). This evidence is hard to reconcile with traditional views of tax avoidance and is consistent with tax authorities providing meaningful monitoring that is beneficial to investors.

While the international evidence discussed above may seem far removed from the developed country setting, an emerging literature has found significant interactions between taxation and corporate governance in the U.S. These empirical investigations are of course hampered by the difficulty of measuring tax avoidance. Building on research in the accounting literature, Desai and Dharmapala (2006a) construct a proxy for tax avoidance activity based on so-called "book-tax gaps" – the difference between financial income as reported to shareholders and an estimate of the tax income reported to the IRS.

In order to test the implications of the agency model discussed above, this measure of tax avoidance can be related to the nature of managerial incentives and to market values to understand how markets value tax avoidance. The results presented in Desai and Dharmapala (2006a) indicate a negative relationship between the use of incentive compensation and tax avoidance measures. This negative relationship contradicts the straightforward view of corporate tax avoidance as simply a means of reducing tax obligations, but is consistent with managerial opportunism being an important consideration and with the existence of complementarities between tax avoidance and managerial opportunism. Moreover, the negative relationship is driven primarily by firms with relatively weaker governance environments, where managerial opportunism is likely to be a more important factor. In a related paper, Desai and Dharmapala (2006c) investigate the effects of their proxy for tax avoidance on firm valuation. Given the theoretical framework sketched above, the central prediction is that firms' governance institutions should be an important determinant of how investors value managers' efforts to avoid corporate taxes.[8] Consistent with this prediction, they find that the impact of tax avoidance on firm value is significantly greater at better-governed firms. This result is robust to the use of a wide variety of controls and various extensions to the model. It also holds when a 1997 change in tax regulations is used as a source of exogenous variation in tax avoidance activity.

The emerging literature on the corporate governance view of taxation has begun to receive support more broadly from a variety of studies. These studies come in two varieties. First, several studies have also noted that market valuations of tax avoidance appear not to be consistent with the naïve view that tax avoidance is a transfer of value from the state to shareholders. For example, Hanlon and Slemrod (2007) study market reactions to news reports about tax sheltering activity by corporations. They find a small negative reaction to news about tax sheltering. However, the reaction is more positive for better-governed firms, which is consistent with the theoretical framework developed in Desai and Dharmapala (2006a) and outlined above. Similarly, Desai and Hines (2002) study market reactions to corporate expatriations or inversions – transactions in which a U.S. parent corporation becomes the subsidiary of its former tax haven subsidiary through a share swap. Although inversions are presumably motivated by tax savings (in particular, the avoidance of U.S. tax on foreign-source income and possibly also the avoidance of tax on U.S. income in certain circumstances), market reactions are not typically positive, as might be expected under the naïve view.

The second type of evidence relates to the role of the IRS as a meaningful monitor of managerial misbehavior. Erickson, Hanlon and Maydew (2004) analyze a sample of firms that

[8] Specifically, tax avoidance should lead to larger increases in firm value at better-governed firms. This is not simply because of a tendency among managers of poorly-governed firms to waste or dissipate a larger share of any value-generating activity they may engage in, but also because complex and obfuscatory tax avoidance activities create a potential shield for managerial opportunism, and this factor will naturally loom larger at firms where governance institutions are weaker.

were found by the SEC to have fraudulently overstated earnings. They find that these firms paid a significant amount of taxes on these fraudulent earnings. This suggests that, at least for this sample of firms, the threat of IRS monitoring of their taxable income loomed larger than did investor monitoring of their financial statements. Similarly, Guedhami and Pittman (2006) find evidence that debt financing is cheaper when the probability of a face-to-face IRS audit is higher. The role of IRS oversight on debt financing costs is also related to the ownership structure of firms and the presumed agency costs of those arrangements. Thus, managers and investors appear to appreciate the role of a tax enforcement agency as a monitor of managerial opportunism.

What are the implications of the corporate governance view of taxation for the conformity debate? First, a system characterized by greater conformity allows for an additional monitor, the IRS, to review the same profit reports that financial investors receive. Second, managers cannot use the distinction between book and tax reports to manufacture profits or reduce tax obligations, as the examples and evidence above suggest they do. Finally, the taxes paid by firms become automatically observable to shareholders thereby making the overall economic performance of firms more transparent.[9]

2. Lowered compliance costs

The case for conformity is strengthened by the fact that operating two parallel reporting systems creates an obvious redundancy in operating costs for firms. These costs are compounded by employing two groups of people with the particular expertise associated with each distinctive system. Slemrod (2006) reviews existing evidence on the compliance costs of taxing large businesses. Estimates of the ratio of compliance costs to revenues raised ranges widely from three to thirty percent. Regardless of the range of these estimates, these costs are thought to be highly regressive, across firm size. And, of course, these costs do not contain estimates of the costs to the U.S. government of enforcing a tax reporting system that is distinct from the reports to capital markets. Compliance costs would not be eliminated in a system with more conformity but clearly some reduction in costs would result. Unfortunately, no reliable estimates exist for such savings.[10]

3. Reduced tax rates on a broader base

Efficient tax policies are characterized by lower rates on a broader base rather than high rates on a narrow base. Lower rates and broader bases allow for reduced behavioral responses to taxes and, consequently, lower deadweight losses associated with raising government revenue. Currently, we appear to have a high marginal tax rate, by global standards, on a relatively narrow base and firms responding, as one might expect, by reducing their tax obligations in other ways. Coupling a move toward greater conformity on the broader base of financial accounting profits with a significantly lower rate could reduce these significant efficiency costs and reduce the efforts by firms to engage in such activities.

[9] An example of this is the recent debate over uncertain tax positions and their accounting. See Gretchen Morgenson, "A Tax Secret Emerges from the Murk" *The New York Times*, January 14, 2007.

[10] The remarkable magnitude of deferred tax assets and liabilities (see Poterba, Seidman and Rao (2007)) also places increasing pressure on firms to explain the valuation of these accounts to rating agencies and investors. While the costs associated with this are unclear, the pervasive nature of these accounts and their growing values are presumably associated with costs that could be limited in a system characterized by greater alignment.

Understanding the precise magnitude of the feasible tax cut requires much more analysis. Rough estimates, elaborated on in Desai (2005), suggest that a 15% tax on reported profits could generate the same revenues as the corporate tax does now. Emphasizing the experience of U.S. multinational firms, Hanlon and Maydew (2006) estimate that conformity could result in revenue-neutral corporate tax reductions to a statutory rate of 26%. These initial efforts to understand what reductions in tax rates could accompany a broadening of the base could usefully be expanded on by government researchers that have tax information available to them.

I. E. Concerns over greater conformity

There are two primary concerns about greater conformity that arise repeatedly in current debates.

1. Political considerations

The primary difficulty with advancing toward greater conformity is the political dimension. There are two possible political consequences that are concerning. First, the government might lose some freedom over tax policy in a totally conformed system. In particular, the ability to change depreciation schedules to provide investment incentives may not exist in a totally conformed system. This concern is mitigated by the fact that few advocate a completely conformed system but instead the use of financial accounting measures as a default, with then accepted departures dictated by policy makers.

The second, and more severe, concern is that accounting bodies would face more lobbying and political pressure from legislative bodies about accounting definitions if taxes were associated with financial accounting definitions. As Zeff (2002) elaborates, financial accounting standard setting bodies have been subject to, and have sometimes accommodated, intense pressure by legislators and firms. Indeed, one such example relates to the treatment of option expensing. With greater conformity, the incidence of such lobbying could increase, particularly as legislators became concerned about the definitions of accounting items that could influence tax policy. A system of absolute conformity would be subject to such concerns, although a reasonable system where financial accounting was the default and exceptions were allowed would seem to be less subject to this concern. Finally, the convergence of accounting systems toward international accounting standards, as described below, might also limit this political pressure as the relevant bodies may be somewhat insulated from political influence through the acknowledgement of supranational standards.

2. Loss of information

Critics of conformity also emphasize the loss of information to investors from a potential conformed system. This loss of information is purported to arise because of a manager's willingness to sacrifice the accuracy of reports to investors and accounting profits in order to save taxes. Evidence for this point of view draws on studies of several countries with conformity as well as analyses of the imposition of conformity in particular parts of the reporting environment.[11]

The cross-country evidence, unfortunately, is limited by the handful of countries that are analyzed and by the fact that this evidence is most properly interpreted as indicating that a cluster of institutions – concentrated ownership, bank based systems and book-tax conformed income –

[11] See for example Hanlon, LaPlante, and Chevlin (2005).

are associated with less informative earnings.[12] Indeed, studies by scholars in countries with conformity experiences (such as Schön, 2005) suggest that many of the concerns over conformity are overstated.

More generally, examining a narrow change to reporting rules toward conformity may also not be informative about a wholesale change toward conformity – much as narrow tax reforms may lead to misleading implications about the consequences of wholesale tax reforms. In short, very little is known about the imposition of conformity from an empirical perspective. As suggested below, recent movements toward conformity in various parts of the world may offer a promising empirical setting for considering these questions. More generally, there is limited theoretical work on the merits or costs of dual reporting systems. Given the centrality of information systems to both tax systems and investor rights, much greater empirical and theoretical work is warranted prior to making any conclusions about the loss of information associated with conformity.[13]

I.F. The international experience with greater conformity

The international experience with conformity is rapidly changing and many countries are now experimenting with greater levels of conformity. These changes have been triggered by the widespread growth of the International Financial Reporting Standards (IFRS) via the International Accounting Standards Board. In short, many large countries have adopted or mimicked IFRS and many others, including the US, have embarked on convergence projects that target the same endpoint.[14]

The EU's mandated use of IFRS has triggered a reevaluation of the degree to which tax accounting should also use IFRS. The advent of IFRS has led commentators to call for the use of IFRS as the logical starting point for tax accounting, creating a potentially sizable degree of conformity. See, for example, Schön (2004, 2005). The current state of play is summarized in Endres, Köhler, Oestreicher, Scheffler, and Spengel (2006) which documents how European Union countries reflect IFRS principles and practices to varying degrees in their tax laws. As described in detail there, considerable overlap exists between IFRS and tax accounting rules. Indeed, the European Union is now considering using the IFRS as the starting point for a Common Consolidated Tax Base. See Norberg (2007) for a discussion of this proposal, a rich set of examples of countries reacting to IFRS and the issues associated with such transitions.

One example of particular note is the United Kingdom. The recent experience in the UK is summarized in Freedman (2004), who details how the advent of IFRS has led to greater, but not complete, conformity in the UK. Specifically, legislative efforts to make IFRS the default definition of income for tax purposes have been followed by case law developments and the actions of standard setters to modify IFRS to accommodate the necessities of tax law. While a complicated transition requiring effort by legislators, standard setters and judges, these efforts

[12] The few studies of this issue include Ball, Kothari and Robin (2000), Ball, Robin and Wu (2003) and Guenther and Young (2000) who consider the effects of reporting environments on the quality of information in a handful of countries.

[13] This concern, while historically relevant, also seems less pressing for the case of public corporations today that prioritize investor perception. These concerns would be even less relevant with lower rates of corporate taxation. It is possible that firms would respond to conformity with a changed emphasis on different definitions of income – so called *pro forma* earnings, for example – to facilitate tax avoidance while preserving positive impressions with investors.

[14] For more on the evolution of IFRS, see Armstrong, Barth, Jagolinzer, and Riedl (2007).

and subsequent development appear to have been successful and have been met with acceptance by companies and investors. There certainly has not been the doomsday outcome suggested by critics of conformity.

Oversimplifying the international experience into countries with and without conformity is not accurate. Accounts of some countries as being hampered by conformity and no longer abiding by it are similarly inaccurate.[15] The advent of IFRS has stimulated many changes in this arena with many countries employing it as an opportunity to advance conformity, with apparently salutary effects. Other countries, such as Germany, are in the midst of reconsidering traditional conformity measures in the world of IFRS. Much more research could be done in the international arena to further understand the effects of conformity, as evidenced by the case examples provided in Freedman (2004), Norberg (2007), Schön (2004, 2005) and Endres, Köhler, Oestreicher, Scheffler, and Spengel (2006). The IRS could also benefit from looking to the experiences of other countries with greater conformity to further understand the potential effects in the U.S. setting.

II. Incentive compensation and its relation to accounting and tax considerations

This section lays out the important role of stock options in incentive compensation, some of the problems created by their use and the role of accounting and tax factors in their use. Finally, some international experience with the tax treatment of options is considered.

II. A. The scope and importance of stock options

Any discussion of stock options and incentive compensation should begin with an appreciation of the problem such instruments are designed to solve. When the ownership and control of public corporations are separated, the managers who run corporations may advance their own interests instead of the interests of shareholders. This agency problem is considered foundational by most economists to understanding how the modern U.S. corporation is governed and how it performs. A critical element to addressing this problem is the use of financial instruments in managerial compensation packages to align their interest with the interests of shareholders. A common variant of this is the granting of stock options to managers.

Figures 1a and 1b provides some simple descriptive statistics on the nature of CEO compensation over the last 15 years based on a widely used dataset employed for analyzing incentive compensation. For these purposes (and consistent with the new accounting rules), CEO compensation is defined to include the value of stock option grants rather than stock options exercises. Several trends are apparent from the figures. First, the magnitude of CEO compensation relative to firm profits rose through the 1990s and has retreated since the early 2000s. Second, the composition of compensation has changed significantly over time as options grew considerably more important through the 1990s. Third, options have recently declined in importance and have been displaced by a variety of other non-cash arrangements. It is clear that any accounting and tax changes to options must be made judiciously given their centrality to compensation arrangements. See Frydman and Saks (2007) and Lemieux, MacCleod, and Parent (2007) for detailed studies of the scope of incentive compensation for executives and the workforce more generally.

Several exhaustive reviews of the literature on stock options exist, such as Murphy (1999), exist obviating the need for a detailed review of their consequences. Several difficulties

[15] Indeed, some commentators have suggested that the dominant trend is toward alignment.

associated with their use have become more apparent recently and can usefully be highlighted here. First, unlike owning straight stock, owners of option contracts face specific stock prices and dates (vesting dates) that can create incentives to meet short term targets.[16] Second, as shown by Rajgopal and Shevlin (2002), Coles, Daniel, and Naveen (2006) and the literature referenced therein, managers with option contract undertake distinctive patterns of finance investment that demonstrate increased risk taking. Third, several commentators have argued, as in Bebchuk and Fried (2004), Bebchuk and Grinstein (2005), and and Bebchuk, Grinstein, and Peyer (2006a, 2006b) that incentive compensation is inherently complicated by the fact that CEOs and directors effectively set their own compensation. Finally, there is some tentative evidence that option grants are associated with an increased likelihood of aggressive accounting or accounting fraud.[17]

II. B. Accounting and Tax Considerations

Do the accounting and tax treatments of stock options influence their use? With respect to the accounting treatment of options, financial accounting does appear to influence option granting behavior, as suggested in early work by Matsunaga (1995). The recent changes in accounting standards have provided researchers the opportunity to study this further and they confirm the role of financial accounting in influence option decision making. For example, Brown and Lee (2007) find that firms most likely to reduce option compensation based on accounting considerations are in fact those that subsequently reduced the use of options the most. In addition to the effects on the types of compensation, Bartov and Hayn (2006) investigate the impact on market valuations. Specifically, they find that the net effect of options expensing on valuation has been, on average, positive due to increased transparency. As such, increased disclosure has been beneficial to market values due to increasing investor confidence in the financial reports.

With respect to the role of taxes and the structure of executive compensation, the evidence is more mixed. Frydman and Saks (2007) report a meaningful role for progressive taxation in altering the nature of executive compensation packages by analyzing changes in executive compensation over a long time series. Perry and Zenner (2001) analyze the impact of Section 162(m)[18] on the composition of executive compensation, concluding that it led to an increase in stock-based forms of compensation (and thus contributed to the rapid growth of incentive pay for executives during the 1990's). However, Rose and Wolfram (2002) find no

[16] For example, see Jensen (2001) for a discussion of the difficulties created by the non-linearities in option contracts. For one example of how options can change behavior, see Bergstresser, Desai and Rauh (2006). For an interesting example of corporate efforts to modify option contracts to reduce this discretion, see the account of recent efforts by Level-3 described in Phred Dvorak, "Tweaking the Stock Option Grant" *The Wall Street Journal*, April 30, 2007. For a more radical proposal on stock options, see Desai and Margolis (2006).

[17] See, for example Bergstresser and Philippon (2006), Kedia and Philippon (2007), Harris and Bromiley (2007), and Ryan, Johnson, and Tian (2007). The recent backdating cases appear to have a limited relationship to the tax treatment of options. There is some possibility that if the taxable event had been the grant date that an additional set of internal monitors (tax lawyers) would have to have been consulted about the validity of the practice. For descriptive accounts of these activities and a legal analysis, see Walker (2007) and Fleischer (2007). For the original research on backdating, see Lie (2005) and Heron and Lie (2006, 2007).

[18] Responding to apparent public concern about the size of CEO salaries, Congress in 1993 enacted Section 162(m) of the tax code, limiting firms' deductibility of executive compensation to $1 million, except where the compensation is "performance-based."

such impact, and attribute the contrary findings of Perry and Zenner (2001) to mean reversion in executive compensation.

While accounting appears to play a clear role in dictating the form of compensation, the effects of taxation are more suggestive of a role.

II. C. International experiences

No other country has quite the same pervasive use of stock options as the U.S.[19] Nonetheless, a brief investigation of how other countries treat the taxation of stock options is worthwhile to see if the system currently employed in the U.S. is the natural or dominant practice. Tables 1 and 2 provide a fairly exhaustive review of how other countries treat options at the individual and corporate level.[20] As the tables demonstrate, there is considerable heterogeneity in how countries treat options, ranging from no corporate deduction to deduction at exercise.

One country where the tax treatment is quite different from the U.S. and where research has been done is Canada. Specifically, there is no tax deduction at the corporate level for option compensation and, until recently, there was no accounting consequence. For more information on this example, see Klassen and Mawani (2000) and Mawani (2003a, 2003b). In this setting, there is further evidence of accounting, in the absence of any conflicting tax considerations, driving the use of stock options.

The heterogeneity of tax treatments internationally is clearly not decisive as to what the U.S. should do. Nonetheless, the variety of experiences globally suggests that there is room for reconsideration of the current U.S. treatment to ensure that it advances the appropriate incentives.

III. Aligning the tax treatment of stock options with the accounting treatment

Switching the timing and value of the corporate tax deduction of stock options to be in alignment with the accounting treatment has several potential advantages.

First, and most obviously, the accounting treatment is based on a reasoned analysis of the appropriate treatment of executive compensation by accounting professionals and standard setters. Bringing the tax treatment in line with the accounting treatment would capitalize on the depth of this analysis. The question before shareholders and tax authorities is the same: what is the value of this compensation and what period is it associated with? It is not clear why the answer of tax authorities should differ from the conclusions of shareholders and accounting standard setters.

Second, as with other movements toward conformity, ensuring that there is one definition of an expense reduces the ability of managers to game the distinction between tax and financial accounting definitions. In this particular case, the use of options could no longer be rationalized as capitalizing on the generous tax deductions that are associated with deductions of exercises versus grants. As such, reconciling accounting and tax treatments would allow for managers and

[19] There are a few studies of comparisons between the U.S. and other countries. See, for example Conyon and Murphy (2000) and Conyon, Core, and Guay (2007).
[20] This material is drawn from OECD (2005). This publication provides a more thorough review of alternative treatments. See also European Commission Entreprise Directorate-General (2003).

investors to make incentive compensation decisions based on their merits without any distortions.

Third, the typical concerns about conformity are likely limited in this setting. It is not clear why lobbying over the treatment of stock options, which has been considerable, would change given the accounting rulings. Nor is it clear why there would be an informational loss to investors. As the evidence on the recent accounting change indicates, simpler disclosure that makes expenses more clear can increase market values and a similar result may obtain with a simpler treatment of tax expenses.

Finally, as the international comparisons presented above make clear, there are precedents for alternative treatments of the tax deduction including deduction at time of exercise and greater alignment with financial accounting definitions in taxation.

Are there offsetting concerns associated with implementing such an alignment? First, it would have be to decided if the treatment of options compensation at the individual level would still need to be coupled with the corporate treatment, as dictated by the matching principle in Section 83 of the IRS code. If the two remain joined, this could raise issues associated with phantom income at the individual level and whether the valuation of grants at the corporate and individual level need necessarily be the same. Second, creating a deduction for stock options at grant will inevitably raise questions of how to treat other compensation arrangements (such as deferred compensation, bonus plans, etc.). As such, it may be useful to revisit the bundle of possible arrangements to ensure some consistency. Finally, estimating the revenue consequences of implementing such a change would be a novel challenge for revenue estimators. But, while considerable, these professionals face more complex problems regularly and are not deterred by such complexities.

In conclusion, this review of the current dual reporting system, the international experience with conformity and expensing stock options, and the review of incentive compensation suggests that aligning the tax treatment with the new accounting rules could preserve the benefits of incentive compensation, reduce current distortions to that choice, and result in a simpler income reporting system.

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Table 1: The taxation of stock options for personal income tax purposes*

Scheme	Benefit as ordinary income	Basis of valuation	Timing of taxation	Notes
AUSTRALIA				
Standard	Yes	Market value	Grant	Medicare levy (0.015) not deductible
Concessionary (1)	Yes	Net value	Exercise	Medicare levy (0.015) not deductible
Concessionary (2)	Yes	Net value (first AUD 1000 deducted)	Grant	Medicare levy (0.015) not deductible
	Yes	Net value (exceeding AUD 1000)	Grant	Medicare levy (0.015) not deductible
AUSTRIA				
Standard	Yes	Net value (up to 50% tax exempt)	Exercise	
	Yes	Net value	Exercise	
BELGIUM				
Concessionary	Yes	15% of the value of the shares.	Grant	
	Yes	7.5% of the value of the shares.	Grant	
CANADA				
Concessionary (public company)				
	(i) Yes	Net market value	Exercise	
	(ii) Yes	50% of net market value	Disposal of shares (if certain conditions are met)	
Concessionary (private company)				
	(i) Yes	Net market value	Disposal of shares	
	(ii) Yes	50% of net market value	Disposal of shares	
Concessionary (phantom)				
	(i) Yes	Market value of bonus paid	Year payment / bonus is received	
	(ii) Yes	50% of market value of bonus paid	Disposal of shares	
Profit sharing plans	Yes	Value of contributions	Year they are made	
CZECH REPUBLIC				
Standard	Yes	Net market value	Grant	
DENMARK				
Standard	Yes	Market value	Exercise	
Concessionary (1)	No	Net market value	Disposal of shares	Benefit taxed as capital gains.
Concessionary (2)	No	Net market value	Disposal of shares	Benefit taxed as capital gains.
FINLAND				
Standard	Yes	Net fair market value	Exercise	
France				
Concessionary (1)-(2)-(3)	No	Net fair market value	Cash	
GERMANY				
Standard (i)	Yes	Net market value (annual allowance)	Exercise	
Standard (ii)	Yes	Net market value	Exercise	
GREECE				
Standard	Yes	Net fair market value	Exercise	
Concessionary	Yes	Net fair market value	Exercise	
Hungary				
Standard	Yes	Net market value	Exercise	
Incentive pay scheme	No	Net value	Cash	Benefit not treated as ordinary employment income
ICELAND				
Standard	Yes	Net market value	Exercise	
Concessionary	No	Net value	Disposal of shares	Benefit taxed as capital gains.

* Tables 1 and 2 are from Organisation for Economic Co-Operation and Development. 2005. "The Taxation of Employee Stock Options." *OECD Tax Policy Studies* 11.

Table 1: The taxation of stock options for personal income tax purposes (cont'd)

IRELAND				
Standard	Yes	Net value	Exercise	
Concessionary (Approved share option schemes)	No	Net market value	Disposal of shares	Provided certain conditions are met benefits are taxed as capital gains. Exemption up to the annual limit applies.
Concessionary (Approved savings related share option schemes)	No	Net market value	Disposal of shares)	Provided certain conditions are met benefit are taxed as capital gains. Exemption up to the annual limit applies.
ITALY				
Standard	Yes	Net value	Grant	
Concessionary	No	Difference between sale price of shares and strike price	Disposal of shares	Benefits are taxed as capital gains.
Incentive pay scheme	No	Difference between sale price and value of the shares at grant	Disposal of shares	Benefits are taxed as capital gains.
JAPAN				
Standard	Yes	Net market value	Exercise	However, provided certain conditions are met benefits are taxed as capital gains at the time of disposal of shares.
KOREA				
Standard	Yes	Net market value	Exercise	
Concessionary	Yes	Net market value	Exercise	
LUXEMBOURG				
Standard				
Options librement négociables	Yes	Net value	Grant	
Options individuelles (i)	Yes	Net value	Exercise	
Options individuelles (ii)	Yes	Net value reduced by 5% each year (until 20%)	Exercise	
MEXICO				
Standard	Yes	Net value	Exercise	
Profit sharing plans	Yes	Paid value (exemption up to 15 days of the minimum wage)	Cash	
NETHERLANDS				
Standard (1)	Yes	Economic value	Grant	
Standard (2)	Yes	Actual obtained profit	Exercise	
NEW ZEALAND				
Standard	Yes	Net market value	Exercise	
NORWAY				
Standard	Yes	Net value	Exercise	
POLAND				
Standard	No	Net market value	Exercise	
PORTUGAL				
Standard	Yes	Net market value	Exercise	
SLOVAK REPUBLIC				
Standard	No	Capital gain on shares	Disposal of shares	Benefit taxed as capital gains.
SPAIN				
Standard				
(i)	Yes	70% of net value	Exercise	
(ii)	Yes	100% of net value	Exercise	
Incentive pay scheme				
(i)	Yes	Value (up to a maximum value of EUR 3 005 per year)	grant	
(ii)	Yes	Value (exceeding EUR 3 005 per year)	grant	

Table 1: The taxation of stock options for personal income tax purposes (cont'd)

SWEDEN				
Standard	Yes	Net market value	Exercise	
SWITZERLAND				
Standard	Yes	n.a.	Exercise or grant	
TURKEY				
Standard	Yes	Market value	Grant	
UK				
Standard (Unapproved schemes)	Yes	Net gain	Exercise	
Concessionary (CSOP, SAYE, EMI)	No	Net market value	Disposal of shares	Assuming scheme conditions are met, benefits are taxed as capital gains determined as the difference between share disposal proceeds and the actual price paid for the shares, plus the cost of the option (if any). Annual exemption applies.
Share Incentive Plan (SIP)	No	Net market value	Disposal of shares	Assuming scheme conditions are met, benefits are taxed as capital gains determined as the difference between share disposal proceeds and their value on the date they are withdrawn from the plan, plus costs of disposal. Annual exemption applies.
Restricted share awards	Yes	Net gain	Acquisition + lifting of each restriction or sale, whichever is earlier	Income Tax and Class 1 National Insurance Contributions liabilities at acquisition on proportion of value reflecting restrictions. Further liabilities when restrictions lifted on proportion of value released at that time. Employer and employee may 'elect' to pay income tax and NICs on full market value at time of acquisition.
Convertible share awards	Yes	Net gain	Acquisition + conversion or sale, whichever is earlier	Income Tax and Class 1 National Insurance Contributions liabilities at acquisition on value of shares, but ignoring right to convert. Further IT & NIC liabilities when conversion takes place, on difference in value between new shares acquired and shares given up.
US				
Nonqualified stock options	Yes	Net fair market value	Exercise	
Incentive stock options	No	Net fair market value	Disposal of shares	Benefit taxed as capital gains.
Employee stock purchase plans	No	Net fair market value	Disposal of shares	Benefit taxed as capital gains.

Table 2: Tax treatment of stock options at corporate level.

Scheme	Deduction for employee stock option compensation	Notes
AUSTRALIA		
Standard and concessionary	No	When stock options are met with newly issued shares the company is not entitled to the deduction. It would be entitled for purchased shares (but this scenario is unlikely)
AUSTRIA		
Standard	No	-
BELGIUM		
Concessionary	No	-
CANADA		
Concessionary (public company)	No	-
Concessionary (private company)	No	-
Concessionary (phantom)	Yes	-
Profit sharing plans	Yes	-
CZECH REPUBLIC		
Standard	Yes	If the stock options are sold or granted to employees not as part of work-related remuneration they are not deductible
DENMARK		
Standard	Yes	-
Concessionary (1)	No	-
Concessionary (2)	Yes	-
FINLAND		
Standard	Yes	When stock options are met with purchased shares. When stock options are met with newly issued shares the company is not entitled to the deduction.
FRANCE		
Concessionary	Yes	When stock options are met with purchased shares. When stock options are met with newly issued shares the company is not entitled to the deduction.
GERMANY		
Standard	Yes	Provided that the employee pays personal income tax on the benefit.
GREECE		
Standard	Yes	-
Concessionary	No	-
HUNGARY		
Standard and incentive scheme	No	-
ICELAND		
Standard	Yes	However, there is no legislative provision as to the treatment of stock options in company accounts or in tax legislation as such.
Concessionary	No	-
IRELAND		
Standard	No	-
Concessionary (Approved share option schemes)	No	-
Concessionary (Approved savings related share option schemes)	No	-
ITALY		
Standard and concessionary	Yes	However, the deduction is not allowed from the regional corporate income tax (IRAP)
JAPAN		
Standard	Yes	When stock options are met with purchased shares. When stock options are met with newly issued shares, the company is not entitled to the deduction.
KOREA		
Standard and concessionary	Yes	When stock options are met with purchased shares. When stock options are met with newly issued shares, the company is not entitled to the deduction.
LUXEMBOURG		
Standard	Yes	-
MEXICO		
Standard	Yes	The loss from the sale of stocks to the employee below market value, if it qualifies as a loss from a plain sale of stocks, is deductible for the corporation only against profits from other sales of stocks, with the possibility of carry forwards.
Profit sharing plans	No	-
NETHERLANDS		
Standard	Yes	The costs of the option at the moment of grant are deductible
NEW ZEALAND		
Standard	No	-

Table 2: Tax treatment of stock options at corporate level (cont'd)

Scheme	Deduction for employee stock option compensation	Notes
NORWAY		
Standard	Yes	When stock options are met with purchased shares
POLAND		
Standard	Yes	When stock options are met with purchased shares
PORTUGAL		
Standard	Yes	The costs are deductible if accounted for as staff costs.
SLOVAK REPUBLIC		
Standard	No	
SPAIN		
Standard	Yes	Spanish companies can only obtain a corporate tax deduction provided the company incurred a real expense. Companies cannot deduct the opportunity cost associated with issuing new shares.
Incentive pay scheme	Yes	Spanish companies can only obtain a corporate tax deduction provided the company incurred a real expense. Companies cannot deduct the opportunity cost associated with issuing new shares.
SWEDEN		
Standard	Yes	-
SWITZERLAND		
Standard	Yes	-
TURKEY		
Standard	Yes	-
UK		
Standard and concessionary schemes	Yes	Automatic for accounting periods starting from 1 January 2003 or later. Only sometimes possible for earlier accounting periods using a case law deduction.
SIP	Yes	-
US		
Nonqualified stock options	Yes	-
Incentive stock options	No	-
Employee stock purchase plans	No	-

Figure 1a: CEO Compensation by Source (Annual Mean Percentage)

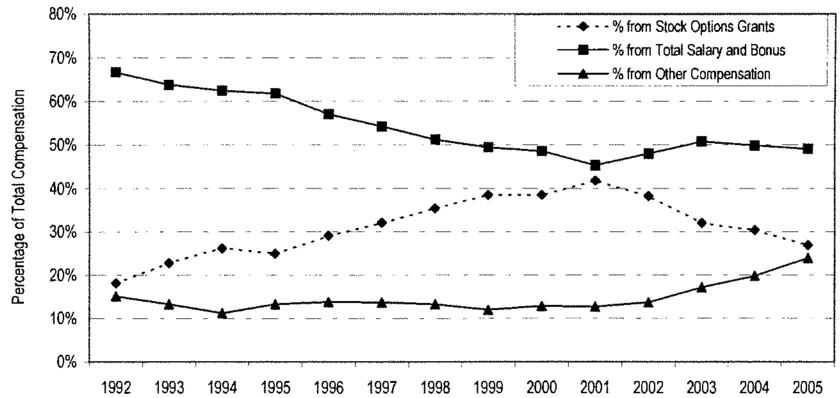
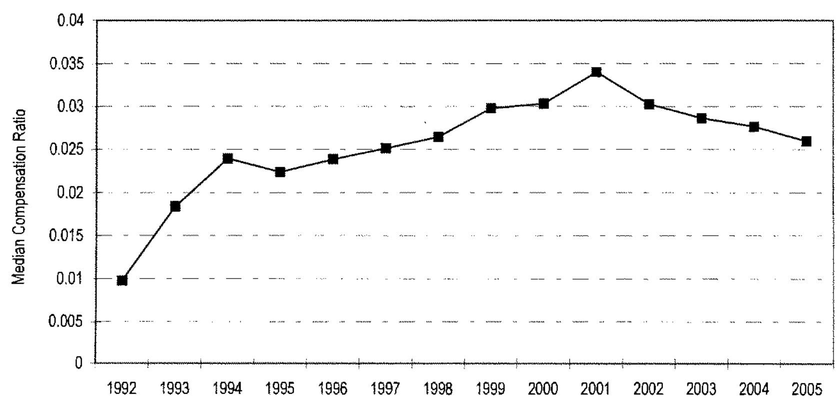


Figure 1b: CEO Total Compensation Relative to Net Income (Annual Median Ratio)



Note: Figure 1 uses a Compustat database that includes measures of executive compensation and firm data. This series began in 1992, with 433 CEOs included in the dataset. The number of CEO observations was 1156 in 1993 and over 1500 every year after. Figure 1a shows the mean by year of percentage of CEO compensation derived from each of three sources: Salary and Bonus, Stock Options Grants, and Other Compensation. Stock Options Grants are option grants valued by the Black-Scholes method. When this value is missing in the dataset, we assumed that the CEO received Stock Options Grants equal to zero. Other Compensation includes restricted stock grants, LTIP payouts, and other non-salary, non-bonus compensation. According to Compustat definitions this includes severence, debt forgiveness, imputed interest, payouts for cancellation of stock options, payment for unused vacation, tax reimbursements signing bonuses, 401K contributions, life insurance premiums, perquisites and other personal benefits, abover market earnings on restricted stock, earnings on LTIP paid during the year but deferred, and difference between the price paid and actual market price for stock under a stock purchase plan not generally available to other shareholders or employees. Figure 1b shows the median by year of the ratio of CEO compensation to firm net income when net income is positive. Net Income is defined by Compustat as Net Income after Extraordinary Items and Discontinued Operations

Source: Standard & Poors's Compustat(R) Execucomp Data, accessed May 23, 2007.

COUNCIL OF
INSTITUTIONAL
INVESTORS

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

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.

COUNCIL OF
INSTITUTIONAL
INVESTORS

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

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.

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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.

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.

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.

[3] See Attachment 3 for a list of the Council's board of directors.

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.

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

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.

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]

[5] See Attachment 2, page 7.

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.

[6] See Attachment 4, pages 2-4.

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 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.

[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.

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

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.

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

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 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]

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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.

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

[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).

of a previously recognized performance-based award will be achieved."[15] In those and 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)

[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).
[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.

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 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

[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.[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.

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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.

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 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]

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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.

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 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

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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).

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

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[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).

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 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

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

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.

[36] See Attachment 4, page 7.

COUNCIL OF
INSTITUTIONAL
INVESTORS

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

Attachment 1

General Members

Council of Institutional Investors

General Members*

Last Updated: August 15, 2006

AFL-CIO Pension Plan

AFSCME Employees Pension Plan

Agilent Technologies Benefit Plans

Alameda County Employees' Retirement Association

Alaska Permanent Fund Corporation

Altria Corporate Services Pension Plan

American Federation of Teachers Pension Plan

Arkansas Public Employees Retirement System

Arkansas Teacher Retirement System

BP America

Bricklayers & Trowel Trades Pension Fund

Building Trades Pension Trust Fund -Milwaukee and Vicinity

California Public Employees' Retirement System

California State Teachers' Retirement System

Campbell Soup Retirement & Pension Plans

Carpenters United Brotherhood Local Unions & Councils Pension Fund

Carpenters Pension Fund Chicago District Council

CERES Defined Contribution Retirement Plan

ChevronTexaco

*General membership in the Council is open to any employee benefit plan, state or local agency officially charged with the investment of plan assets, or non-profit endowment funds and non-profit foundations. General Members participate in all meetings and seminars sponsored by the Council and are the only voting members of the Council. Annual dues are $1.30 per $1 million in fund assets, but no less than $3,000 and no more than $30,000.

CIGNA Pension Fund

Coca-Cola Retirement Plan

Colgate-Palmolive Employees' Retirement Income Plan

Colorado Fire and Police Pension Association

Colorado Public Employees' Retirement Association

Communications Workers of America Pension Fund

Connecticut Retirement Plans and Trust Funds

Contra Costa County Employees' Retirement Association

CWA/ITU Negotiated Pension Plan

Dallas Employees' Retirement Fund

Delaware Public Employees Retirement System

Detroit General Retirement System

Disney (Walt)

District of Columbia Retirement Board

ELCA Board of Pensions

Fairfax County Educational Employees' Retirement System

Fannie Mae

Florida State Board of Administration

Gap

General Mills Retirement Plan

General Motors Investment Management

Hartford Municipal Employees Retirement Fund

Hewlett-Packard

Houston Firefighters' Relief & Retirement Fund

I.A.M. National Pension Fund

IBEW Pension Benefit Fund

Idaho Public Employee Retirement System

Illinois State Board of Investment

Illinois State Universities Retirement System

Illinois Teachers' Retirement System

Iowa Municipal Fire & Police Retirement System

Iowa Public Employees Retirement System

ITT Industries Pension Fund Trust

IUE-CWA Pension Fund

Jacksonville Police and Fire Pension Fund

Jeffrey Company

Johnson & Johnson

Kentucky Retirement Systems

Kern County Employees' Retirement Association

KeyCorp Cash Balance Pension Plan

Laborers' Central Pension Fund

LIUNA Local Union & District Council Pension Fund

Los Angeles City Employees' Retirement System

Los Angeles County Employees Retirement Association

Los Angeles Fire and Police Pension System

Lucent Technologies Pension Plan

Maine State Retirement System

Marin County Employees' Retirement Association

Maryland, State Retirement Agency

Massachusetts Bay Transportation Authority Retirement Fund

Massachusetts PRIM

McDonald's Employee Benefits Plan

Microsoft

Milwaukee Employees' Retirement System

Minnesota State Board of Investment

Missouri Public School & Non-Teacher School ERS

Missouri State Employees' Retirement System

Montgomery County Employees' Retirement System

Nathan Cummings Foundation

National Education Association Retirement Plan

Navy-Marine Corps Relief Society

New Hampshire Retirement System

New Jersey Division of Investment

New York City Employees' Retirement System

New York City Pension Funds

New York City Board of Education Retirement System

New York City Fire Department Pension Fund

New York City Police Pension Fund

New York City Teachers' Retirement System

New York State and Local Retirement System

New York State Teachers' Retirement System

North Carolina Retirement System

Ohio Police & Fire Pension Fund

Ohio Public Employees Retirement System

Ohio School Employees Retirement System

Ohio State Teachers' Retirement System

Operating Engineers Central Pension Fund

Pennsylvania Public School Employees' Retirement System

Pennsylvania State Employees' Retirement System

Pfizer

Pitney Bowes Pension Plan

Plumbers & Pipefitters National Pension Fund

Producer-Writers Guild

Rhode Island Employees' Retirement System

Sacramento County Employees' Retirement System

San Diego City Employees' Retirement System

San Francisco City & County Employees' Retirement System

San Jose City Retirement Systems

Santa Barbara County Employees' Retirement System

Schering-Plough Employees' Savings Plan

Sealed Air Retirement Plans

SEIU Union Pension Fund

Sheet Metal Workers' Local 19 Pension Plan

Sheet Metal Workers' National Pension Fund

Sunoco

Target

Teamster Affiliates Pension Plan

Tennessee Consolidated Retirement System

Texas Employees Retirement System

Texas Municipal Retirement System

Texas Teacher Retirement System

UFCW Staff Trust Fund

UNITE HERE Laundry & Dry Cleaning Workers Pension Fund

UNITE HERE National Retirement Fund

UNITE HERE Textile Workers Pension Fund

United States Steel and Carnegie Pension Fund

Virginia Retirement System

Washington State Investment Board

West Virginia Investment Management Board

Wisconsin State Investment Board

World Bank Staff Retirement Plan

Xerox Corporation

COUNCIL OF
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Attachment 2

Council Corporate Governance Policies

The Council of Institutional Investors
Corporate Governance Policies

CONTENTS:

I. Introduction

The Council expects that corporations will comply with all applicable federal and state laws and regulations and stock exchange listing standards.

The Council believes every company should also have written disclosed governance procedures and policies, an ethics code that applies to all employees and directors, and provisions for its strict enforcement. The Council posts its corporate governance policies on its web site (www.cii.org); it hopes corporate boards will meet or exceed these standards and adopt similarly appropriate additional policies to best protect shareowners' interests.[1]

In general, the Council believes that corporate governance structures and practices should protect and enhance accountability to, and ensure equal financial treatment of, shareowners. An action should not be taken if its purpose is to reduce accountability to shareowners.

The Council also believes shareowners should have meaningful ability to participate in the major fundamental decisions that affect corporate viability, and meaningful opportunities to suggest or nominate director candidates and to suggest processes and criteria for director selection and evaluation.

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[1] At the February 2006 meeting of the Council's Policies Committee, it was decided that Council policies should use the term "shareowner" instead of "shareholder," reflecting the Council's belief that the former term is a better descriptor.

The Council believes companies should adhere to responsible business practices and practice good corporate citizenship. Promotion, adoption and effective implementation of guidelines for the responsible conduct of business and business relationships are consistent with the fiduciary responsibility of protecting long-term investment interests.

The Council believes good governance practices should be followed by publicly traded companies, private companies and companies in the process of going public. As such, the Council believes that, consistent with their fiduciary obligations to their limited partners, the general members of venture capital, buyout and other private equity funds should use appropriate efforts to encourage companies in which they invest to adopt long-term corporate governance provisions that are consistent with the Council's policies.

The Council believes that U.S. companies should not reincorporate offshore because corporate governance structures there are weaker and therefore reduce management accountability to shareowners.

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

II. The Board of Directors

Annual election of directors. All directors should be elected annually (no classified boards).

Director elections: When permissible under state law, companies' charters and by-laws should provide that directors in uncontested elections are to be elected by a majority of the votes cast. In contested elections, plurality voting should apply. An election is contested when there are more director candidates than there are available board seats. Boards should adopt policies asking that directors tender their resignations if they fail to win majority support in uncontested elections, and providing that such directors will not be renominated after expiration of their current term in the event they fail to tender such resignation.

Independent board. At least two-thirds of the directors should be independent (i.e., their only non-trivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is their directorship). The company should disclose information necessary for shareowners to determine whether directors qualify as independent, whether or not the disclosure is required by state or federal law. This information should include all financial or business relationships with and payments to directors and their families and all significant payments to companies, non-profits, foundations and other organizations where company directors serve as employees, officers or directors. (See Council definition of independent director.)

All-independent board committees. Companies should have audit, nominating and compensation committees, and all members of these committees should be independent. The board (not the CEO) should appoint the committee chairs and members. Committees should be able to select their own service providers. Some regularly scheduled committee meetings should be held with only the committee members (and, if appropriate, the committee's independent consultants) present. The process by which committee members and chairs are selected should be disclosed to shareowners.

Board accountability to shareowners
Majority shareowner votes. Boards should take actions recommended in shareowner proposals that receive a majority of votes cast for and against. If shareowner approval is required for the action, the board should submit the proposal to a binding vote at the next shareowner meeting.
Interaction with shareowners. Directors should respond to communications from shareowners and should seek shareowner views on important governance, management and performance matters. All directors should attend the annual shareowners' meeting and be available, when requested by the chair, to answer shareowner questions.

Shareowner – director communication, interaction & meeting conduct. Directors should respond to communications from shareowners and should seek shareowner views on important governance, management and performance matters. To accomplish this goal, all companies should establish a mechanism by which shareowners with non-trivial concerns could communicate directly with all directors, including independent directors. Policies requiring that all director communication go through a member of the management team should be avoided unless they are for record-keeping purposes. In such cases, procedures documenting receipt, delivery to the board and response must be maintained and made available upon request to shareowners.
During the annual general meeting, shareowners should have the right to ask questions, both orally and in writing, and expect answers and discussion where appropriate from the board of directors. Such discussion should take place regardless whether those questions have been submitted in advance. All directors should attend the annual shareowners' meetings and be available, when requested by the chair, to answer shareowner questions. While reasonable time limits to questions asked might be acceptable, the board should not ignore or skip hearing questions because a shareowner has a smaller number of shares or has not held those shares for a certain amount of time.

Independent chair/lead director. The board should be chaired by an independent director. The CEO and chair roles should only be combined in very limited circumstances; in these situations, the board should provide a written statement in the proxy materials discussing why the combined role is in the best interests of shareowners, and it should name a lead independent director who should have approval over information flow to the board, meeting agendas, and meeting schedules to ensure a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors.
Other roles of the lead independent director should include chairing meetings of nonmanagement directors and of independent directors, presiding over board meetings in the absence of the chair, serving as the principle liaison between the independent directors and the chair, and leading the board/director evaluation process. Given these

additional responsibilities, the lead independent director should expect to devote a greater amount of time to board service than the other directors.

Board/director evaluation. Boards should evaluate themselves and their individual members on a regular basis. Board evaluation should include an assessment of whether the board has the necessary diversity of skills, backgrounds, experiences, ages, races and genders appropriate to the company's ongoing needs. Individual director evaluations should include high standards for in person attendance at board and committee meetings and disclosure of all absences or conference call substitutions.
Boards should review the performance and qualifications of any director from whom at least 10 percent of the votes cast are withheld.
Absent compelling and stated reasons, directors who attend fewer than 75 percent of board and board-committee meetings for two consecutive years should not be renominated.
Companies should disclose individual director attendance figures for board and committee meetings. Disclosure should distinguish between in-person and telephonic attendance. Excused absences should not be categorized as attendance.

'***Continuing directors***.' Corporations should not adopt so-called "continuing director" provisions (also known as "dead-hand" poison pills) that allow former directors who have left office to take action on behalf of the corporation.

Board size and service. Absent compelling, unusual circumstances, a board should have no fewer than 5 and no more than 15 members (not too small to maintain the needed expertise and independence, and not too large to be efficiently functional). Shareowners should be allowed to vote on any major change in board size.
Companies should establish and publish guidelines specifying on how many other boards their directors may serve. Absent unusual, specified circumstances, directors with full-time jobs should not serve on more than two other boards. Currently serving CEOs should only serve as a director of one other company, and then only if the CEO's own company is in the top half of its peer group. No person should serve on more than five for-profit company boards.

Board operations. Directors should receive training from independent sources on their fiduciary responsibilities and liabilities. Directors have an affirmative obligation to become and remain independently familiar with company operations; they should not rely exclusively on information provided to them by the CEO to do their jobs.
Directors should be provided meaningful information in a timely manner prior to board meetings, and should be allowed reasonable access to management to discuss board issues. Directors should be allowed to place items on board agendas.
Non-management directors should hold regularly scheduled executive sessions without the CEO or staff present. The independent directors should also hold regularly scheduled in-person executive sessions without non-independent directors and staff present.
The board should approve and maintain a CEO succession plan.

Auditor independence. As prescribed by law, the audit committee has the responsibility to hire, oversee and, if necessary, fire the company's outside auditor.
The audit committee should seek competitive bids for the external audit engagement no less frequently than every five years.
The company's external auditor should not perform any non-audit services for the company, except those required by statute or regulation to be performed by a company's external auditor, such as attest services.
The proxy statement should also include a copy of the audit committee charter and a statement by the audit committee that it has complied with the duties outlined in the charter.
Companies should not agree to limit the liability of outside auditors.
Audit committee charters should provide for annual shareowner votes on the board's choice of independent, external auditor. Such provisions ought to state that if the board's selection fails to achieve the support of a majority of the for-and-against votes cast, the audit committee should: (1) take the shareowners' views into consideration and reconsider its choice of auditor; and (2) solicit the views of major shareowners in order to determine why broad levels of shareowner support were not achieved.

Charitable and political contributions. The board of directors should monitor, assess and approve all charitable and political contributions (including trade association contributions) made by the company. The board should ensure that only contributions consistent with and aligned to the interests of the company and its shareowners are approved. The terms and conditions of such contributions should be clearly defined and approved by the board. The board's guidelines for contribution approval should be publicly disclosed as a corporate contributions policy.
The board should disclose on an annual basis the amounts and recipients of all monetary and non-monetary contributions made by the company during the prior fiscal year. If any expenditures earmarked for political or charitable activities were provided to or through a third-party, then those expenditures should be included in the report.

III. Shareowner Voting Rights

The shareowners' right to vote is inviolate and should not be abridged.

Access to the proxy. Companies should provide access to management proxy materials for a long-term investor or group of long-term investors owning in aggregate at least 5 percent of a company's voting stock to nominate less than a majority of the directors. Eligible investors must have owned the stock for at least three years. Company proxy materials and related mailings should provide equal space and equal treatment of nominations by qualifying investors.

One share, one vote. Each share of common stock should have one vote. Corporations should not have classes of common stock with disparate voting rights. Authorized unissued common shares that have voting rights to be set by the board should not be issued with unequal voting rights without shareowner approval.

Confidential voting. All proxy votes should be confidential, with ballots counted by independent tabulators. Confidentiality should be automatic and permanent and apply to all ballot items. Rules and practices concerning the casting, counting and verifying of shareowner votes should be clearly disclosed.
Voting requirements. A majority vote of common shares outstanding should be sufficient to amend company bylaws or take other action requiring or receiving a shareowner vote. Supermajority votes should not be required.
A majority vote of common shares outstanding should be required to approve:
*Major corporate decisions concerning the sale or pledge of corporate assets that would have a material effect on shareowner value. Such a transaction will automatically be deemed to have a material effect if the value of the assets exceeds 10 percent of the assets of the company and its subsidiaries on a consolidated basis.
*The corporation's acquiring 5 percent or more of its common shares at above-market prices other than by tender offer to all shareowners.
*Poison pills.
*Abridging or limiting the rights of common shares to (i) vote on the election or removal of directors or the timing or length of their term of office, or (ii) make nominations for directors or propose other action to be voted on by shareowners, or (iii) call special meetings of shareowners or take action by written consent or affect the procedure for fixing the record date for such action.
*Provisions resulting in the issuance of debt to a degree that would excessively leverage the company and imperil the long-term viability of the corporation.

Broker votes. Broker non-votes and abstentions should be counted only for purposes of a quorum.

Bundled voting. Shareowners should be allowed to vote on unrelated issues separately. Individual voting issues, particularly those amending a company's charter, bylaws or anti-takeover provisions, should not be bundled.

IV. Shareowner Meetings

Corporations should make shareowners' expense and convenience primary criteria when selecting the time and location of shareowner meetings.
Appropriate notice of shareowner meetings, including notice concerning any change in meeting date, time, place or shareowner action, should be given to shareowners in a manner and within time frames that will ensure that shareowners have a reasonable opportunity to exercise their franchise. Polls should remain open at shareowner meetings until all agenda items have been discussed and shareowners have had an opportunity to ask and receive answers to questions concerning them.
Companies should not adjourn a meeting for the purpose of soliciting more votes to enable management to prevail on a voting item. Extending a meeting should only be done for compelling reasons such as vote fraud, problems with the voting process or lack of a quorum.

Companies should hold shareowner meetings by remote communication (so-called electronic or "cyber" meetings) only as a supplement to traditional in-person shareowner meetings, not as a substitute.
As noted in Section II, "The Board of Directors", all directors should attend the annual shareowners' meeting and be available, when requested by the chair, to respond directly to oral or written questions from shareowners.

V. Executive Compensation

The Council believes that executive compensation is a critical and visible aspect of a company's governance. Pay decisions are one of the most direct ways for shareowners to assess the performance of the board. And they have a bottom line effect, not just in terms of dollar amounts, but also by formalizing performance goals for employees, signaling the market and affecting employee morale.

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 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. They 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. For example, all companies should provide annually for advisory shareowner votes on the compensation of senior executives.

ROLE OF COMPENSATION COMMITTEE
The compensation committee is responsible for structuring executive pay, evaluating executive performance within the context of the pay structure of the entire company, subject to approval of the board of directors. To best handle this role, the Council believes that compensation committees should adopt the following principles and practices:

Structure

• ***Committee composition***: All members of the compensation committee should be independent. Committee membership should rotate periodically among the board's independent directors. Members should be or take responsibility to become knowledgeable about compensation and related issues. They should exercise due diligence and independent judgment in carrying out their committee responsibilities. They should represent diverse backgrounds and professional experiences.

Responsibilities

• ***Executive pay philosophy***: The compensation philosophy should be clearly disclosed to shareowners in annual proxy statements. In developing, approving and monitoring the executive pay philosophy, the compensation committee should consider the full range of pay components, including structure of programs, desired mix of cash and equity awards, goals for distribution of awards throughout the company, how executive pay relates to the pay of other employees, use of employment contracts, and policy regarding dilution.
• ***Oversight***: The compensation committee should vigorously oversee all aspects of executive compensation for a group composed of the CEO and other highly paid executives, as required by law, and any other highly paid employees, including executives of subsidiaries, special purpose entities and other affiliates, as determined by the compensation committee. The committee should ensure that the structure of employee compensation throughout the company is fair, non-discriminatory and forward-looking, and that it motivates, recruits and retains a workforce capable of meeting the company's strategic objectives. To perform its oversight duties, the committee should approve, comply with and fully disclose a charter detailing its responsibilities.
• ***Pay for performance***: Compensation of the executive oversight group should be driven predominantly by performance. The compensation committee should establish performance measures for executive compensation that are agreed to ahead of time and publicly disclosed. Performance measures applicable to all performance-based awards (including annual and long-term incentive compensation) should reward superior performance—based predominantly on total stock return measures and key operational measures—at minimum reasonable cost and should reflect downside risk.
• ***Annual approval and review***: Each year, the compensation committee should review performance of individuals in the oversight group and approve any bonus, severance, equity-based award or extraordinary payment made to them. The committee should understand all components of executive compensation and annually review total compensation potentially payable to the oversight group under all possible scenarios, including death/disability, retirement, voluntary termination, termination with and without cause and changes of control. The committee should also ensure that the structure of pay at different levels (CEO and others in the oversight group, other executives and non-executive employees) is fair and appropriate in the context of broader company policies and goals and fully justified and explained.
• ***Committee accountability***: In addition to attending all annual and special shareowner meetings, committee members should be available to respond directly to questions about executive compensation; the chair of the committee should take the lead. In addition, the committee should regularly report on its activities to the independent directors of the board, who should review and ratify committee decisions. Committee members should

take an active role in preparing the compensation committee report contained in the annual proxy materials, and be responsible for the contents of that report.

• ***Outside advice***: The compensation committee should retain and fire outside experts, including consultants, legal advisers and any other advisers when it deems appropriate, including when negotiating contracts with executives. Individual compensation advisers and their firms should be independent of the client company, its executives and directors and should report solely to the compensation committee. 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. Companies should not agree to indemnify or limit the liability of compensation advisers or the advisers' firms.

Proxy statement disclosure

• ***Disclosure practices***: The compensation committee is responsible for ensuring that all aspects of executive compensation are clearly, comprehensively and promptly disclosed, in plain English, in the annual proxy statement regardless of whether such disclosure is required by current rules and regulations. The compensation committee should disclose all information necessary for shareowners to understand how and how much executives are paid and how such pay fits within the overall pay structure of the company. It should provide annual proxy statement disclosure of the committee's compensation decisions with respect to salary, short-term incentive compensation, long-term incentive compensation and all other aspects of executive compensation, including the relative weights assigned to each component of total compensation. Other recommended disclosures relevant to specific elements of executive compensation are detailed below.

• ***Benchmarking***: Benchmarking at median or higher levels is a primary contributor to escalating executive compensation. Although benchmarking can be a constructive tool for formulating executive compensation packages, it should not be relied on exclusively. If benchmarking is used, compensation committees should commit to annual disclosure of the companies in peer groups used for benchmarking and/or other comparisons. If the peer group used for compensation purposes is different from that used to compare overall performance, such as the five-year stock return graph required in the annual proxy materials, the compensation committee should describe the differences between the groups and the rationale for choosing between them. In addition to disclosing names of companies used for benchmarking and comparisons, the compensation committee should disclose targets for each compensation element relative to the peer/benchmarking group and year-to-year changes in companies composing peer/benchmark groups.

SALARY

Since salary is one of the few components of executive compensation that is not "at risk," it should be set at a level that yields the highest value for the company at least cost. In general, salary should be set to reflect responsibilities, tenure and past performance, and to be tax efficient—meaning no more than $1 million. The compensation committee should publicly disclose its rationale for paying salaries above the median of the peer group.

ANNUAL INCENTIVE COMPENSATION

Cash incentive compensation plans should be structured to appropriately align executive interests with company goals and objectives and to reasonably reward superior performance that meets or exceeds well-defined and clearly disclosed performance targets that reinforce long-term strategic goals set and approved by the board and written down in advance of the performance cycle.

Structure

• ***Formula plans***: The compensation committee should approve formulaic bonus plans containing specific qualitative and quantitative performance-based operational measures designed to reward executives for superior performance related to operational/strategic/other goals set by the board. Such awards should be capped at a reasonable maximum level. These caps should not be calculated as percentages of accounting or other financial measures (such as revenue, operating income or net profit), since these figures may change dramatically due to mergers, acquisitions and other nonperformance-related strategic or accounting decisions.

• ***Targets***: When setting performance goals for "target" bonuses, the compensation committee should set performance levels below which no bonuses would be paid and above which bonuses would be capped.

• ***Changing targets***: Except in unusual and extraordinary situations, the compensation committee should not "lower the bar" by changing performance targets in the middle of bonus cycles. If performance targets must be lowered, amended or changed in the middle of a performance cycle, reasons for the change and details of the initial targets and adjusted targets should be disclosed.

Proxy statement disclosure

• ***Transparency***: The compensation committee should commit to provide full descriptions of the qualitative and quantitative performance measures and benchmarks used to determine annual incentive compensation, including the weightings of each measure. At the beginning of a period, the compensation committee should calculate and disclose the maximum compensation payable if all performance-related targets are met. At the end of the performance cycle, the compensation committee should disclose actual targets and details on the determination of final payouts.

Disgorgement

Executives should be required to repay incentive compensation to the company in the event of malfeasance involving the executive, or fraudulent or misleading accounting that results in substantial harm to the corporation.

Shareowner approval

Shareowners should approve the establishment of, any material amendments to, annual incentive compensation plans covering the oversight group.

LONG-TERM INCENTIVE COMPENSATION

Well-designed compensation programs can lead to superior performance. Long-term incentive compensation, generally in the form of equity-based awards, can be structured

to achieve a variety of long-term objectives, including retaining executives, aligning executives' financial interests with the interests of shareowners, and rewarding the achievement of long-term specified strategic goals of the company and/or the superior performance of company stock.
But long-term incentive compensation comes at a cost, and poorly structured awards permit excessive or abusive pay that is detrimental to the company and to shareowners. To maximize effectiveness and efficiency, compensation committees should carefully evaluate the costs and benefits of long-term incentive compensation, ensure that long-term compensation is appropriately structured and consider whether performance and incentive objectives would be enhanced if awards were distributed throughout the company, not simply to top executives.

Companies may rely on a myriad of long-term incentive vehicles—including, but not limited to, performance-based restricted stock/units, phantom shares, stock units and stock options—to achieve a variety of long-term objectives. While the technical underpinnings of long-term incentive awards may differ, the Council believes that the following principles and practices apply to all long-term incentive compensation awards. And, as detailed below, certain policies are relevant to specific types of long-term incentive awards.

Structure
• ***Size of awards***: Compensation committees should set appropriate limits on the size of long-term incentive 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 long-term incentive awards, followed by pro rata vesting over at least two subsequent years for senior executives.
• ***Grant timing***: Except in extraordinary circumstances, such as a permanent change in performance cycles, long-term incentive awards should be granted at the same time each year. Companies should not coordinate stock award grants with the release of material non-public information. The grants should occur whether recently publicized information is positive or negative, and stock options 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) equity-based awards granted as long-term incentive compensation or other stock holdings in the company. And, they should strongly discourage other employees from hedging their holdings in company stock.

Proxy statement disclosure
• ***Philosophy/strategy***: Compensation committees should have a well-articulated philosophy and strategy for long-term incentive compensation, 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 each type of long-

term incentive award granted to the executive oversight group and how each component contributes to long-term performance objectives of a company.

• ***Ownership targets***: Compensation committees should disclose whether and how long-term incentive compensation 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 long-term incentive compensation is appropriately used to meet ownership targets.

Disgorgement

Executives should be required to repay long-term incentive compensation to the company in the event of malfeasance involving the executive, or fraudulent or misleading accounting that results in substantial harm to the corporation.

Shareowner approval

Shareowners should approve all long-term incentive plans, including equity-based plans, any material amendments to existing plans or any amendments of outstanding awards to shorten vesting requirements, reduce performance targets or otherwise change outstanding long-term incentive awards to benefit executives. Plans should have expiration dates and not be structured as "evergreen," rolling plans.

DILUTION

Dilution measures how much the additional issuance of stock may reduce existing shareowners' stake in a company. Dilution is particularly relevant for long-term incentive compensation plans since these programs essentially issue stock at below-market prices to the recipients. The potential dilution represented by long-term incentive compensation plans is a direct cost to shareowners.

Dilution from long-term incentive compensation plans may be evaluated using a variety of techniques including, but not limited to, the reduction in earnings per share and voting power resulting from the increase in outstanding shares.

Proxy statement disclosure

• ***Philosophy/strategy***: Compensation committees should develop and disclose the philosophy regarding dilution including definition(s) of dilution, peer group comparisons and specific targets for annual awards and total potential dilution represented by equity compensation programs for the current year and expected for the subsequent four years.

• ***Stock repurchase programs***: Stock buyback decisions are a capital allocation decision and should not be driven solely for the purpose of minimizing dilution from equity-based compensation plans. The compensation committee should provide information about stock repurchase programs and the extent to which such programs are used to minimize the dilution of equity-based compensation plans.

• ***Tabular disclosure***: The annual proxy statement should include a table detailing the overhang represented by unexercised options and shares available for award and a discussion of the impact of the awards on earnings per share.

STOCK OPTION AWARDS
Stock options give holders the right, but not the obligation, to buy stock in the future. Options may be structured in a variety of ways. The Council considers some structures and policies preferable because they more effectively ensure that executives are compensated for superior performance. Other structures and policies are inappropriate and should be prohibited.

Structure—preferred practices
• ***Performance options***: Stock option 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 options, but distributed only upon exercise of the option.
• ***Stock option expensing***: Since stock options have a cost, companies should include these costs as an expense on their reported income statements and disclose valuation assumptions.

Structure—inappropriate practices
• ***Discount options***: No discount options should be awarded.
• ***Reload options***: Reload options should be prohibited.
• ***Option repricing***: "Underwater" options should not be repriced or replaced (either with new options or other equity awards), unless approved by shareowners. Repricing programs, for shareowner approval, should exclude directors and executives, restart vesting periods and mandate value-for-value exchanges in which options are exchanged for a number of equivalently valued options/shares.

STOCK AWARDS/UNITS
Stock awards/units and similar equity-based vehicles generally grant holders stock based on the attainment of performance goals and/or tenure requirements. These types of awards are more expensive to the company than options, since holders generally are not required to pay to receive the underlying stock, and therefore should be limited in size.

Structure
Stock awards should be linked to the attainment of specified performance goals and in some cases to additional time-vesting requirements. Stock awards should not be payable based solely on the attainment of tenure requirements.

Proxy statement disclosure
• ***Transparency***: The compensation committee should provide full descriptions of the qualitative/quantitative performance measures and benchmarks used and the weightings of each component. Whenever possible, disclosure should include details of performance targets.

PERQUISITES
Company perquisites blur the line between personal and business expenses. The Council believes that executives, not companies, should be responsible for paying personal expenses—particularly those that average employees routinely shoulder, such as family and personal travel, financial planning, club memberships and other dues. The compensation committee should ensure that any perquisites are warranted and have a legitimate business purpose, and it should consider capping all perquisites at a de minimis level. Total perquisites should be described, disclosed and valued.

EMPLOYMENT CONTRACTS, SEVERANCE AND CHANGE-OF-CONTROL PAYMENTS
Various arrangements may be negotiated to outline terms and conditions for employment and to provide special payments following certain events, such as a termination of employment with/without cause and/or a change in control. The Council believes that these arrangements should be used on a limited basis.

Structure
• ***Employment contracts***: Companies should only provide employment contracts to executives in limited circumstances, such as to provide modest, short-term employment security to a newly hired or recently promoted executive. Such contracts should have a specified termination date (not to exceed three years); contracts should not be "rolling" on an open-ended basis.
• ***Severance payments***: Executives should be entitled to severance payments in non-control change situations only in the event of wrongful termination, death or disability. Termination for poor performance, resignation under pressure or failure to renew the contract should not qualify as wrongful termination.
• ***Change-in-control payments***: Any provisions providing for compensation following a change-in-control event should be "double-triggered," stipulating that compensation is payable only (1) after a control change actually takes place and (2) if a covered executive's job is terminated because of the control change.

Limitations
• ***Gross-ups***: Companies should not compensate executives for any excise or additional taxes payable upon the receipt of severance, change-in-control or similar payments.

Proxy statement disclosure
• ***Transparency***: The compensation committee should fully and clearly describe the terms and conditions of employment contracts and any other agreements/arrangements covering the executive oversight group and reasons why the compensation committee believes the agreements are in the best interests of shareowners.
• ***Tabular disclosure***: The compensation committee should provide tabular disclosure of the dollar value payable, including gross-ups and all related taxes payable by the company, to each member of the executive oversight group under each scenario covered by the contracts/agreements/arrangements, including change-in-control, death/disability termination with/without cause and resignation.

• ***Timely disclosure***: New executive employment contracts or amendments to existing contracts should be immediately disclosed in 8-K filings and promptly disclosed in subsequent 10-Qs.

Shareowner ratification
Shareowners should ratify all employment contracts, side letters or other agreements providing for severance, change-in-control or other special payments to executives exceeding 2.99 times average annual salary plus annual bonus for the previous three years.

RETIREMENT ARRANGEMENTS
Deferred compensation plans, supplemental executive retirement plans, retirement packages and other retirement arrangements for highly paid executives can result in hidden and excessive benefits. The Council believes that special retirement arrangements, including ones structured to permit employees whose compensation exceeds IRS limits to fully participate in similar plans covering other employees, should be consistent with programs offered to the general workforce, and they should be reasonable.

Structure
• ***Supplemental executive retirement plans (SERPs)***: Supplemental plans should be an extension of the retirement program covering other employees. They should not include special provisions, such as above-market interest rates and excess service credits, not offered under plans covering other employees. Payments such as stock and stock options, annual/long-term bonuses and other compensation not awarded to other employees and/or not considered in the determination of retirement benefits payable to other employees should not be considered in calculating benefits payable under SERPS.
• ***Deferred compensation plans***: Investment alternatives offered under deferred compensation plans for executives should mirror those offered to employees in broad-based deferral plans.

Limitations
• ***Deferred compensation plans***: Above-market returns should not be applied to executive deferrals, and executives should not receive "sweeteners" for deferring cash payments into company stock.
• ***Post-retirement exercise periods***: Executives should be limited to three-year postretirement exercise periods for stock option grants.
• ***Retirement benefits***: Executives should not be entitled to special perquisites—such as apartments, automobiles, use of corporate aircraft, security, financial planning—and other benefits upon retirement. Executives are highly compensated employees who should be more than able to cover the costs of their retirements.

Proxy statement disclosure
• ***Transparency***: The terms of any deferred compensation, retirement, SERP or other similar plans covering the executive oversight group should be fully disclosed, in plain English, along with a description of any additional perquisites or benefits payable to executives after retirement.

• ***Tabular disclosure***: A single table should be provided detailing the expected dollar value payable to each member of the executive oversight group under any deferred compensation, retirement, SERP or similar plan, along with a dollar value of any additional perquisites of benefits payable after retirement.

STOCK OWNERSHIP

Structure

• ***Stock ownership***: Executives and directors should own, after a reasonable period of time, a meaningful position in the company's common stock. Executives should be required to own stock—excluding unexercised options and unvested stock awards—equal to a multiple of salary, scaled based on position, such as two times salary for lower-level executives and up to six times salary for the CEO.

Limitations

• ***Stock sales***: Executives should be required to sell stock through pre-announced program sales or by providing a minimum 30-day advance notice of any stock sales.

• ***Post-retirement holdings***: Executives should be required to continue to satisfy the minimum stock holding requirements for at least six months after leaving the company.

Proxy statement disclosure

• ***Transparency***: Companies should disclose stock ownership requirements and whether any members of the executive oversight group are not in compliance.

VI. Non-Employee Director Compensation

Given the vital importance of the responsibilities assigned to directors, the Council expects that non-employee directors will devote significant time to their boardroom duties.

The Council believes that policy issues related to director compensation are fundamentally different from executive compensation. The Council is supportive of director compensation policies that accomplish the following goals: 1) attract highly qualified candidates; 2) retain highly qualified directors; 3) align directors' interests with those of the long-term owners of the corporation; and, 4) provide complete disclosure to shareowners regarding all components of director compensation including the philosophy behind the program and all forms of compensation.

To accomplish these goals, director compensation should consist solely of a combination of cash retainer and equity-based compensation. The cornerstone of director compensation programs should be alignment of interests through the attainment of significant equity holdings in the company meaningful to each individual director. The Council believes that equity obtained with an individual's own capital provides the best alignment of interests with other shareowners. However, compensation plans can provide supplemental means of obtaining long-term equity holdings through equity compensation, long-term holding requirements and ownership requirements.

The Council believes that companies should have flexibility within certain broad policy parameters to design and implement director compensation plans that suit their unique circumstances. To support this flexibility, investors must have complete and clear disclosure of both the philosophy behind the compensation plan as well as the actual compensation awarded under the plan. Without full disclosure, it is increasingly difficult to earn investors' confidence and support for compensation plans, including both director and executive plans.

Although non-employee director compensation is generally immaterial to a company's bottom line and small relative to executive pay, the Council believes that director compensation is an important piece of a company's governance. Because director pay is set by the board and has inherent conflicts of interest, care must be taken to ensure there is no appearance of impropriety.

Companies should pay particular attention to managing these conflicts.

ROLE OF THE COMPENSATION COMMITTEE IN DIRECTOR COMPENSATION

The compensation committee (or alternative committee comprised solely of independent directors) is responsible for structuring director pay, subject to approval of all the independent directors, so that it is aligned with the long-term interests of shareowners. The unique fact that directors are setting their own compensation necessitates additional emphasis on the following practices:

Responsibilities

• ***Total compensation review***: The compensation committee should understand and value each component of director compensation and annually review total compensation potentially payable to each director.

• ***Outside advice***: The Council believes that committees should have the ability to utilize a compensation consultant for assistance on director compensation plans. In cases where the compensation committee does utilize a consultant, it should always retain an independent compensation consultant or any other advisors as deemed appropriate to assist with the evaluation of the structure and value of director compensation. A summary of the pay consultant's advice should be provided in the annual proxy statement in plain English. The compensation committee should disclose all instances where the consultant is also retained (by the committee) to provide advice on executive compensation. In no circumstances should the committee utilize a consultant for director compensation or executive compensation who is also retained by management.

Proxy statement disclosure

• ***Tabular disclosure***: Annual proxy statement disclosure should include a table with columns valuing each component of compensation paid to each director during the previous year. The table should also include a column estimating the total value, including the present value of equity awards, of each director's annual pay package and any other relevant information. The table should include the number of board meetings and committee meetings attended by the director.

• ***Compensation committee report***: The annual director compensation disclosure included in the proxy materials should include a discussion of the philosophy for director pay and the processes for setting director pay levels. Reasons for changes in director pay programs should be explained in plain English. Peer group(s) used to compare director pay packages should be fully disclosed, along with differences, if any, from the peer group(s) used for executive pay purposes. While the Council recognizes the value of peer analysis, we do not believe that peer-relative justification should dominate the rational for (higher) pay levels. Rather, compensation programs should be appropriate for the circumstances of the company. The report should disclose how many committee meetings involved discussions of director pay.

The following sections provide Council policy positions on specific components of director compensation and related issues.

RETAINER

The annual retainer should be the sole form of cash compensation paid to non-employee directors. Ideally, it should reflect an amount appropriate for a director's expected duties, including attending meetings, preparing for meetings/discussions and performing due diligence on sites/operations (which should include routine communications with a broad group of employees.) The Council recognizes that in some combination, the retainer and the equity component combined also reflect the director's contribution from experience and leadership.

The Council opposes meeting attendance fees—whether for board meetings or committee meetings—since meeting attendance is the most basic expectation of a non-employee director.

Retainer amounts may be differentiated to recognize that certain non-employee directors, possibly including independent board chairs, independent lead directors, committee chairs or members of certain committees, are expected to spend more time on board duties than other directors.

The board should have a clearly defined attendance policy. In cases where the committee utilizes any form of financial consequences (loss of a portion of the retainer or equity) as part of the director compensation program, this should be fully disclosed. Financial consequences for poor attendance, while perhaps appropriate in some circumstances, should not be considered in lieu of examining the attendance record, commitment (time spent on director duties) and contribution as integral criterion in director performance and re-nomination decisions.

EQUITY-BASED COMPENSATION

To complement the annual retainer and align director-shareowner interests, non-employee directors shall receive stock awards or stock-related awards such as phantom stock or share units. Equity-based compensation to non-employee directors should be fully vested on the grant date. This point is a marked difference to the Council's policy on executive compensation which calls for performance-based vesting of equity-based awards. While views on this topic have been mixed, the Council believes that the benefits of immediate vesting outweigh the complications. The obvious benefits stem from the immediate alignment of interests with shareowners and the maintenance of independence and objectivity for the director.

The Council believes that equity-based compensation can be an important component of director compensation. These tools are perhaps best suited to accomplish optimal long-term perspective and alignment of interests with shareowners. To accomplish this objective, the Council believes that director compensation should contain an ownership requirement or incentive and minimum holding period requirements.

The Council suggests ownership requirements of at least three to five times annual compensation. However, the Council is sensitive to situations where qualified director candidates may not have financial means to obtain immediate ownership thresholds. For this reason, companies may adopt unique approaches to providing either a minimum threshold for ownership or incentive to build ownership. This concept should be an integral component of the committee's disclosure related to the philosophy of director pay. It is appropriate to provide a reasonable period of time for directors to meet ownership requirements or guidelines.

Separate from ownership requirements, the Council believes companies should adopt holding requirements for a significant majority of equity-based grants. These policies should require that directors retain a significant portion (such as 80% for example) of equity grants until after they are retired from the board. These policies should also prohibit the use of any transactions or arrangements that mitigate the risk or benefit of ownership to the director. The Council believes that these transactions and arrangements will inhibit the alignment of interests obtained from providing equity compensation and ownership requirements.

The Council does not advocate a specific split between equity-based and cash compensation. Rather, we believe that companies should have the flexibility to set and adjust this ratio as may be appropriate for the circumstances. Accordingly, the rational behind this decision is an important element of disclosures related to the overall philosophy of director compensation.

Proxy statement disclosure

• ***Transparency***: The present value of equity awards paid to each director during the previous year and the philosophy and process used in determining director pay should be fully disclosed in the proxy statement.

Shareowner approval

• Current listing standards require shareowner approval of equity-based compensation plans and material amendments to plans (with limited exceptions). The Council strongly supports this concept and advocates that companies adopt conservative interpretations of approval requirements when confronted with choices. (For example, this may include material amendments to the plan).

PERFORMANCE-BASED COMPENSATION

While the Council is a strong advocate of performance-based concepts in executive compensation, we do not support performance measures in director compensation. Performance-based compensation for directors has significant potential to conflict with the director's primary role as an independent representative of shareowners.

PERQUISITES

Aside from meeting-related expenses such as air–fare, hotel accommodations and modest travel/accident insurance, the Council believes that directors should receive no other perquisites. Health, life and other forms of insurance, matching grants to charities,

financial planning, automobile allowances and other similar perquisites cross the line as benefits offered to employees. The Council believes that charitable awards programs are an unnecessary benefit; directors interested in posthumous donations can do so on their own via estate planning.
Infrequent token gifts of modest value are not considered perquisites.

REPRICING AND EXCHANGE PROGRAMS
The Council believes that under no circumstances should directors participate in or be eligible for repricing or exchange programs.

EMPLOYMENT CONTRACTS, SEVERANCE AND CHANGE-OF-CONTROL PAYMENTS
Non-employee directors should not be eligible to receive any change-in-control payments or severance arrangements of any kind.

RETIREMENT ARRANGEMENTS
Since non-employee directors are elected representatives of shareowners and not company employees, they should not be offered retirement benefits such as defined benefit plans or deferred stock awards nor should they be entitled to special post-retirement perquisites.
The Council does not object to allowing directors to defer cash pay via a deferred compensation plan for directors. However, the Council believes that such investment alternatives offered under deferred compensation plans for directors should mirror those offered to employees in broad-based deferral plans. Non-employee directors should not receive "sweeteners" for deferring cash payments into company stock.

DISGORGEMENT
Directors should be required to repay compensation to the company in the event of malfeasance or a breach of fiduciary duty involving the director.

VII. Independent Director Definition

Members of the Council of Institutional Investors believe that the promulgation of a narrowly drawn definition of an independent director (coupled with a policy specifying that at least two-thirds of board members and all members of the audit, compensation and nominating committees should meet this standard) is in the corporation's and all shareowners' ongoing financial interest because:

□ independence is critical to a properly functioning board,

□ certain clearly definable relationships pose a threat to a director's unqualified independence in a sufficient number of cases that they warrant advance identification,

□ the effect of a conflict of interest on an individual director is likely to be almost impossible to detect, either by shareowners or other board members, and,

□ while an across-the-board application of *any* definition to a large number of people will inevitably miscategorize a few of them, this risk is sufficiently small that it is far outweighed by the significant benefits.

Thus, the members of the Council approved the following basic definition of an independent director:

an independent director is someone whose only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship.

Stated most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation.

The members of the Council recognize that independent directors do not invariably share a single set of qualities that are not shared by non-independent directors. Consequently no clear rule can unerringly describe and distinguish independent directors. However, the independence of the director depends on all relationships the director has, including relationships between directors, that may compromise the director's objectivity and loyalty to shareowners. It is the obligation of the directors to consider all relevant facts and circumstances, to determine whether a director is to be considered independent. The notes that follow are supplied to give added clarity and guidance in interpreting the specified relationships.

A director will not be considered independent if he or she:

(a) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, employed by the corporation or employed by or a director of an affiliate; An "affiliate" relationship is established if one entity either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote more than 20 percent of the equity interest in another, unless some other person, either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote a greater percentage of the equity interest. For these purposes, joint venture partners and general partners meet the definition of an affiliate, and officers and employees of joint venture enterprises and general partners are considered affiliated. A subsidiary is an affiliate if it is at least 20 percent owned by the corporation.

Affiliates include predecessor companies. A "predecessor" is an entity that within the last 5 years was party to a "merger of equals" with the corporation or represented more than 50 percent of the corporation's sales or assets when such predecessor became part of the corporation.

"Relatives" include spouses, parents, children, step-children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, aunts, uncles, nieces, nephews and first cousins, and anyone sharing the director's home.

(b) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, an employee, director or **greater-than-20-percent** owner of a firm that is one of the corporation's or its affiliate's paid advisers or consultants or that receives revenue of at least $50,000 for being a paid adviser or consultant to an executive officer of the corporation;

NOTES: Advisers or consultants include, but are not limited to, law firms, auditors, accountants, insurance companies and commercial/investment banks. For purposes of this definition, an individual serving "of counsel" to a firm will be considered an employee of that firm.

The term "executive officer" includes the chief executive, operating, financial, legal and accounting officers of a company. This includes the president, treasurer, secretary, controller and any vice-president who is in charge of a principal business unit, division or function (such as sales, administration or finance) or performs a major policymaking function for the corporation.

(c) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, employed by or has had a 5 percent or greater ownership interest in a third-party that provides payments to or receives payments from the corporation **and either (i) such payments account for 1 percent of the third-party's or 1 percent of the corporation's consolidated gross revenues in any single fiscal year, or (ii) if the third-party is a debtor or creditor of the corporation and the amount owed exceeds 1 percent of the corporation's or third party's assets.** Ownership means beneficial or record ownership, not custodial ownership.

(d) has, or in the past 5 years has had, or whose relative has paid or received more than $50,000 in the past 5 years under, a personal contract with the corporation, an executive officer or any affiliate of the corporation;

NOTES: Council members believe that even small personal contracts, no matter how formulated, can threaten a director's complete independence. This includes any arrangement under which the director borrows or lends money to the corporation at rates better (for the director) than those available to normal customers -- even if no other services from the director are specified in connection with this relationship.

(e) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, an employee or director of a foundation, university or other non-profit organization that receives significant grants or endowments from the corporation, one of its affiliates or its executive officers or has been a *direct* beneficiary of *any* donations to such an organization;

NOTES: A "significant grant or endowment" is the lesser of $100,000 or 1 percent of total annual donations received by the organization.

(f) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, part of an interlocking directorate in which the CEO or other employee of the corporation serves on the board of a third-party entity (for-profit or not-for-profit) employing the director **or such relative**;

(g) has a relative who is, or in the past 5 years has been, an employee, a director or a 5 percent or greater owner of a third-party entity that is a significant competitor of the corporation; or

(h) is a party to a voting trust, agreement or proxy giving his/her decision making power as a director to management except to the extent there is a fully disclosed and narrow voting arrangement such as those which are customary between venture capitalists and management regarding the venture capitalists' board seats.
The foregoing describes relationships between directors and the corporation. The Council also believes that it is important to discuss relationships between directors on the same board which may threaten either director's independence. A director's objectivity as to the best interests of the shareowners is of utmost importance and connections between directors outside the corporation may threaten such objectivity and promote inappropriate voting blocks. As a result, directors must evaluate all of their relationships with each other to determine whether the director is deemed independent. The board of directors shall investigate and evaluate such relationships using the care, skill, prudence, and diligence that a prudent person acting in a like capacity would use.

(updated March 20, 2007).

COUNCIL OF
INSTITUTIONAL
INVESTORS

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

Attachment 3

Council Board of Directors

Council Board of Directors

Council Officers

Jack Ehnes
Board Chair
California State Teachers' Retirement System

Peggy Foran
Co-Chair
Pfizer Retirement Annuity Plan

Bruce Raynor
Co-Chair
UNITE HERE National Retirement Fund

Kathy-Ann Reissman
Co-Chair
Employees Retirement System of Texas

Gail Stone
Treasurer
Arkansas Public Employees' Retirement System

Warren Mart
Secretary
I.A.M. National Pension Fund

Ann Yerger
Executive Director *(non-board member)*
Council of Institutional Investors

Board Members

Mary Collins
The District of Columbia Retirement Board

Peter Gilbert
Pennsylvania State Employees' Retirement System

Benny Hernandez
Sheet Metal Workers' National Pension Fund

Richard Metcalf
Staff Pension Plan of LIUNA

D. Craig Nordlund
Agilent Technologies Benefit Plans

Joe Dear
Washington Statement Investment Board

Jody Olson
Idaho Public Employees Retirement System

Dennis Johnson
California Public Employees' Retirement System

Meredith Williams
Public Employees' Retirement Association of Colorado

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Attachment 4

Council Correspondence Referenced in Full Text of Statement

Council Correspondence Referenced in Full Text of Statement

1. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to The Honorable Barney Frank, House of Representatives (Apr. 5, 2007).
2. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Conrad Hewitt, Chief Accountant, Securities and Exchange Commission (Apr. 2, 2007) (including attachment Compensation Valuation, Inc., Zions Bancorporation ESOARS: An Evaluation, Mar. 30, 2007).
3. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Conrad Hewitt, Chief Accountant, Securities and Exchange Commission (Feb. 5, 2007).
4. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Nancy M. Morris, Secretary, Securities and Exchange Commission (Jan. 25, 2007).
5. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to The Honorable Richard C. Shelby, Committee on Banking, Housing, and Urban Affairs, United States Senate (Sept. 8, 2006).
6. Letter from Ann Yerger, Executive Director, Council of Institutional Investors to Nancy M. Morris, Secretary, Securities and Exchange Commission (June 21, 2006).
7. Letter from Ann Yerger, Executive Director, Council of Institutional Investors to Nancy M. Morris, Secretary, Securities and Exchange Commission (Mar. 29, 2006) (including Appendix I).

COUNCIL OF INSTITUTIONAL INVESTORS

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Via Hand Delivery

April 5, 2007

The Honorable Barney Frank
House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

On behalf of the members, board of directors, and staff of the Council of Institutional Investors ("Council"), I am writing to congratulate you on the Committee on Financial Services ("Committee") successful mark-up of H.R. 1257, the "Shareholder Vote on Executive Compensation Act."

The Council is an association of more than 135 corporate, public and union pension funds with more than $3 trillion in pension assets. Council members are responsible for investing and safeguarding assets used to fund pension benefits of millions of participants and beneficiaries throughout the United States ("US"). Since the average member invests approximately 75 percent of its entire pension portfolio in US stocks and bonds, issues relating to US corporate governance and the Committee's critical oversight role with respect to those issues are of great interest to our members.

The Council believes that executive compensation is a critical and visible aspect of a company's governance. Pay decisions are one of the most direct ways for shareowners to assess the performance of the board.

On March 20, 2007, the Council's general members unanimously approved the following revision to the Council's corporate governance policies:

> Companies should provide annually for advisory shareowner votes on the compensation of senior executives.

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

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") 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 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 drugmaker *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.

Thank you again for your leadership and efforts to improve corporate governance practices. We look forward to continuing to work closely with you and your staff to ensure that the US capital market system continues to serve the needs of investors.

Sincerely,

Jeff Mahoney

Jeff Mahoney
General Counsel

cc: The Honorable Spencer Bachus, Ranking Member, Committee on Financial Services
The Honorable Paul E. Kanjorski, Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
The Honorable Deborah D. Pryce, Ranking Member, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
The Honorable Christopher J. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs
The Honorable Richard C. Shelby, Ranking Member, Committee on Banking, Housing, and Urban Affairs
The Honorable Jack Reed, Chairman, Subcommittee on Securities, Insurance, and Investment
The Honorable Wayne Allard, Ranking Member, Subcommittee on Securities, Insurance, and Investment

COUNCIL OF INSTITUTIONAL INVESTORS

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Via Hand Delivery

April 2, 2007

Conrad Hewitt
Chief Accountant
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Zions Bancorporation ESOARS

Dear Mr. Hewitt:

I am writing on behalf of the Council of Institutional Investors, an association of more than 135 public, corporate and union pension funds with combined assets of over $3 trillion ("Council"). This letter is a follow-up to our letter to you of February 5, 2007,[1] regarding your office's approval of Zions Bancorporation's ("Zions") Employee Stock Option Appreciation Rights Securities ("ESOARS") for use as a market-based approach for valuing employee share-based payment awards under Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* ("Statement 123R").[2] We very much appreciate your February 23, 2007, letter in response to our February 5th letter, and the related telephone call by Joe Ucuzoglu of your office.[3]

As indicated in our February 5th letter, the Council has been, and continues to be, a strong proponent of Statement 123R.[4] We believe Statement 123R improves financial accounting and reporting of share-based payment awards by requiring that, consistent with the Council's corporate governance policies, all employee share-based payment awards be accounted for as compensation costs appropriately reducing reported earnings.[5] We also are a strong proponent of the fair value measurement objective and related implementation guidance contained in Statement 123R.[6] We agree, as stated in that guidance, that "[o]bservable market prices of identical or similar equity or liability

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[1] Letter from Jeff Mahoney, General Counsel, *Council of Institutional Investors*, to Conrad Hewitt, Chief Accountant, *Securities and Exchange Commission* (Feb. 5, 2007).
[2] Letter from Conrad Hewitt, Chief Accountant, *Securities and Exchange Commission*, to Mr. James G. Livingston, Vice President, *Zions Bancorporation* 1 (Jan. 25, 2007) ("Based on our review of your Submissions, and subject to your adoption of the modifications recommended in the following paragraph, the SEC staff concurs with your view that the ESOARS instrument is sufficiently designed to be used as a market-based approach to valuing employee share-based payment awards under Statement 123R.").
[3] Letter from Conrad Hewitt, Chief Accountant, *Securities and Exchange Commission*, to Jeff Mahoney, General Counsel, *Council of Institutional Investors* (Feb. 23, 2007).
[4] Letter from Jeff Mahoney, *supra* note 1, at 1 n.3.
[5] *Id.* at 1 n.4.
[6] *Id.* at 1.

instruments in active markets are the best evidence of fair value and, if available, should be used as the basis for the measurement of equity and liability instruments awarded in a share-based payment transaction with employees."[7]

As also indicated in our February 5th letter, and in my telephone conversation with Mr. Ucuzoglu, the Council would ". . . (1) carefully analyze Zions' ESOARS, (2) consult with leading valuation and accounting experts, and (3) report to your office any concerns about whether the approach produces sufficiently reliable values for financial reporting purposes."[8] Since February 5th I have had numerous informal conversations with many leading valuation and accounting experts to obtain their views on Zions' ESOARS. In addition, the Council retained Compensation Valuation Inc. ("CVI"), a firm specializing in the valuation of employee stock options, to perform an evaluation of Zions' ESOARS.

CVI's report containing its assessment and recommended remedies regarding the "suitability of the ESOARS product for purposes of financial disclosure under FAS 123R" is attached to this letter for your review ("CVI Report").[9] In summary, consistent with the views of other leading valuation and accounting experts, the CVI Report concludes:

> . . . the ESOARS product is too flawed to serve as a reliable valuation tool for FAS 123R purposes. While the tracking security itself is imperfect but not unreasonable, in combination with the auction mechanism and surrounding conditions and incentives, the design serves primarily to produce a predictably downward biased result.[10]

The CVI Report offers several "major modifications" designed to remedy the defects with Zions' ESOARS including: (1) significantly increasing the issuance size and eliminating the artificial restrictions on bidders and holders of Zions' ESOARS, and (2) reversing the Zions' ESOARS so that Zions (and other companies valuing their employee stock options) must purchase (rather than sell) the ESOARS from third party suppliers.[11] The CVI Report notes that

> . . . [w]ithout remedies or alternatives such as those proposed above, the ESOARS price should not be accepted by auditors nor certified by senior executives as correctly measuring the cost of a company's ESOs.[12]

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[7] Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, ¶ A7 (footnote omitted).
[8] Letter from Jeff Mahoney, *supra* note 1, at 2.
[9] Compensation Valuation Inc., Zions Bancorp ESOARS: An Evaluation 1 (March 30, 2007).
[10] *Id.* at 6; *see also* William Ortner et al., *Equity Compensation and the Capital Markets*, Citigroup Corporate and Investment Banking 19 (Aug. 15, 2006) (Zions' ESOARS result . . . "in the 'market' bid for the instrument certainly being a lowball one.").
[11] Compensation Valuation, Inc., *supra* note 9, at 6-8.
[12] *Id.* at 8.

As indicated in our February 5th letter, it is our understanding that Zions plans to hold an auction for ESOARS within the next few weeks for purposes of valuing their own employee stock options for financial accounting and reporting.[13] It is also our understanding that Zions plans to "handle" ESOARS auctions for a number of clients in the coming months and that those companies will use the auctions to value and report the fair value of their own employee stock options.[14]

Given the findings of the CVI Report and the results of my conversations with other leading valuation and accounting experts, we are deeply concerned that Zions' ESOARS will result in information reported to investors that will not faithfully reflect the true costs of an enterprise's employee share-based awards. Investors have long been misled about the costs of employee share-based compensation, as evidenced most recently in connection with the far too common practice of stock option backdating.

Given the magnitude of employee share-based compensation (over $40 billion for the S&P 500),[15] and its continued prevalent use, investors cannot afford to continue to be given purposely biased information about the costs of these awards. We, therefore, would respectfully request that your office prohibit Zions and all other public companies from using the Zions' ESOARS product to value employee share-based payment awards for financial accounting and reporting purposes unless and until the fundamental failings of the product have been remedied.

We look forward to meeting with you and other SEC staff in the near future to discuss this letter and the CVI Report in more detail. In the meantime, please contact me with any questions or if you need any additional information.

Sincerely,

Jeff Mahoney

Jeff Mahoney
General Counsel

Attachment

CC: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Kathleen L. Casey
Commissioner Annette L. Nazareth
Chester Spatt, Chief Economist, Office of Economic Analysis

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[13] David Reilly and Serena Ng, *SEC Clears Market-Based Way To Value Staff Stock Options*, Wall St. J., Jan. 30, 2007, at C5.
[14] *SEC approves Zions' stock-option valuation system*, Salt Lake Trib., Jan. 31, 2007, at 1.
[15] Jack T. Ciesielski, *A Sputtering Love Affair: Stock Options of the S&P 500, 2005*, 15 Analyst's Acct. Observer 1 (May 2, 2006).

John W. White, Director, Division of Corporation Finance

Zions Bancorporation ESOARS: An Evaluation

by

Compensation Valuation, Inc. (CVI)

30 March 2007

This report was prepared by Stephen A. Ross with the assistance of Rick Antle, Greta Hotopp, Andrew Jeffrey, and Richard Roll, principals of CVI, at the request of the Council of Institutional Investors. CVI is a company specializing in the valuation of employee stock options. Brief bios of the principals are appended at the end of the report. CVI has never had a business relation with Zions Bancorporation.

Assignment

Zions Bancorporation (Zions) has developed a product, ESOARS, which is intended to help determine the value of employee stock options (ESOs) for purposes of financial disclosure under FAS 123R. The Council of Institutional Investors (CII) has solicited my opinion and that of CVI on the suitability of the ESOARS product for purposes of FAS 123R.

The ESOARS Security

The ESOARS security is designed to track the payoffs of a company's ESOs.[16] It will be sold in a public auction to fix its value and, by inference, the value of the associated ESOs.[17] The ESOARS security is a tracking instrument that pays the holder a constant fraction of the actual payouts made by the company to its employees as they exercise their options. To adjust for pre-vesting forfeitures, security holders will be reimbursed for their original bid, with interest, on a pro rata basis.[18] In the event of a modification of the terms of the ESOs, e.g., an altered strike price, Zions has the right to cancel the security at a price to be determined by a third party.[19] The cancellation procedure is not well described, although a model-based valuation is mentioned.

Possible cancellation introduces an element of uncertainty that can potentially lead to a significant divergence between the value of the ESOARS security and the value of a perfect tracking instrument not subject to cancellation at modification. With this exception, though, a correct value for the ESOARS security would serve as a benchmark for the cost to the company of issuing ESOs.

We turn now to the proposed auction mechanism for valuing ESOARS.

The ESOARS Auction

The ESOARS auction is meant to mimic the Treasury auction.[20] Participants submit bids for the tracking security consisting of the amount they wish to acquire at specified prices. These offer prices are arrayed from highest to lowest in a simulated demand curve for the security. The actual sale price is determined as the highest price such that the aggregate

[16] "Zions Bancorporation ESOARS, Summary prepared for: Office of the Chief Accountant, Securities and Exchange Commission" at: https://www.esoarsauction.com/pma/faq/zions_submission.pdf ("Summary"), page 6.
[17] Summary, p.2.
[18] "ESOARS holders will be reimbursed, with interest, for the pro rata share of the amount paid for the ESOARS securities for employee stock options in the reference pool that are forfeited prior to vesting," https://www.esoarsauction.com/pma/faq/#is5. This was not the case for the 2006 auction.
[19] Summary, p. 8.
[20] References to the U.S. Treasury are made in relation to the choice of format ("Modified Dutch auction" section, p. 12), resolutions of tie bids ("Tie bids at stop price" section, p. 13), and limitations on bids ("Maximum bid amounts" section, p. 15), and elsewhere, Summary, pages 12, 13, and 15.

of the offers at and above that price just consumes the supply. If total demand at the sale price exceeds supply, then the highest offers are satisfied first while those who bid exactly the sale price are allocated securities in proportion to the amount they offered to buy (although subject to restrictions as described below).

ESOARS For Purposes of FAS 123R

The value of any asset or security is most reliably determined by its price in a well-functioning liquid market that attracts adequate interest from investors. Such a market has low transactions costs and is able to absorb a large volume of trade with minimal price impact. A consistently small bid/ask spread is a typical attribute of such a liquid market.

The security being traded must have adequate public information for market participants to form a reasoned opinion of value, and the security must be supplied in a quantity sufficient to warrant the attention of investors and speculators and cover the cost of information processing relative to asset value. Participants in the market for complex securities typically rely on models to determine their own assessments of value, but the market price aggregates disparate views and is the best representation of value. Because of these features, a liquid market is said to lead to price discovery.

Similar conditions apply to auctions. To produce a good estimate for the value of the security being sold, the auction must have low barriers to entry so that it can attract the interest of many informed and well-capitalized buyers. Ideally, it should attract institutional buyers who have the capacity to model the product, particularly for a security with ESOARS's complexity. An auction is one-sided in that potential bidders decide whether or not to participate and, if so, to what extent; when an auction attracts many bidders with sufficient resources, competition prevents the sale price from undervaluing the security. On the other hand, when bidding is restricted and competitive forces are weakened, one can expect undervaluation.

Unfortunately, the ESOARS auction is not likely to fulfill the conditions to permit true price discovery. Difficulties arise from restrictions placed on participants in the ESOARS auction, from the small size being offered and from incentives of the seller. Further dampening conditions include a contingency to eliminate competitive bidding, delays in payments to security holders, mandatory account-holding by winning bidders post-auction with Zions' brokerage arm (Zions Direct) and pre-auction consideration of each bidder's Zions Direct balance, which affects the maximum bid allowed. In addition, bidders are faced with the prospect of an unsupported secondary market and undefined third-party valuations affecting the virtual "callability" of the security upon ESO modification.

Not surprisingly, these factors preclude the ESOARS auction mechanism from satisfying the basic requirements for liquidity and price discovery and make it highly likely that the ESOARS auction price will significantly understate the true cost of ESOs to the firm.

We will now explain in more detail how various auction features impact the resulting sale price.

Bidder Cost/Benefit

The small size of the offering (actual proceeds in Zions' June auction were only $702,075 and the restricted maximum bid was just $350,000[21]) makes the security unsuitable for large or institutional holders. The additional requirement that any winning bidder become (if not already one at the time of the auction) a customer of Zions Direct would be a further barrier for some investors. It is particularly ominous that Zions takes into account the size of the customer's deposit in determining the maximum allowable bid. The suggestion that bidders who are pre-auction customers of Zions Direct may be allowed a larger bid is a serious barrier to institutional involvement.

The diminutive size of the issue has other predictable effects. In their summary to the Office of the Chief Accountant of the SEC, Zions reported that there were 82 registered bidders, 57 of whom actually made bids. They note that there were 5 institutions amongst the 82 registered bidders, although they do not identify how many of those actually submitted bids.[22] The small scale makes it uneconomic for an investor to exert significant effort in studying the offering. At CVI, we were approached by a hedge fund seeking a valuation, but, upon learning of the restrictions and the size of the ESOARS offering, they decided not to participate. To the extent that this is a typical reaction, the bidders who did participate would be far from a representative sample of investors.

Perhaps the closest market that currently exists to securities such as the ESOARS is the market for individual company stock options. The average trading volume in Zions options, for example, is approximately 300 per day,[23] i.e., options on 30,000 individual shares. By contrast, the Zions auction was for 93,610 units. To put this in perspective, the auction represented around the same number of underlying shares as the average number of Zions options traded in the listed market over a three-day period. It is important to realize that listed options are by comparison much simpler instruments than the ESOARS security and that investors can hedge them with positions in the underlying stock (and vice versa). Moreover, they are traded in two-sided, low cost, liquid secondary markets supported by multiple market-makers.

By contrast, the ESOARS instrument is sui generis, less convenient to hedge or to use as a hedge, not tradable in an efficient two-sided aftermarket, and not a simple substitute for holding the stock itself. Unlike a warrant issued by a company or a private placement, information about the issuing company is a smaller component of the ESOARS' value; instead, they are more subject to the proclivities of Zions employees.

[21] Summary, p. 15.

[22] The reported number of bidders, number of institutions, and number who made bids, Summary, p. 15.

[23] Calculated from The Options Clearing Corporation's online Volume Query results, data for the period 26 March 2006 through 26 March 2007, divided by two to represent one contract side, and divided by 252 to represent an average daily volume of over 296 over the one-year period, http://www.optionsclearing.com/market/volume/volbyproduct_form.jsp as accessed on 26 March 2007.

FAS 123R requires that the ESO valuation represents the actual cost to the company of its employee option grant payouts. But if the limited market supply results in a low ESOARS value, this has nothing to do with actual ESO costs. It does indicate that the auction is not sufficiently well functioning to enable price discovery.

Lack of a Supported Secondary Market

The lack of commitment to a secondary market further diminishes the potential for a reliable valuation in the initial auction, and removes a check on the validity of price discovery. All investors are reluctant to take on a position that can only be unwound at significant discount from inherent value. ESOARS are in this aspect analogous to unregistered stock, which invariably sells at a discount. Subsequent illiquidity in the ESOARS secondary market renders the purchase a 'buy-and-hold' decision --an unattractive feature at any size.

Zions states that there are no restrictions on the transfer or sale of the ESOARS and that there may not be an active secondary market for ESOARS.[24] While it states its intention to facilitate an aftermarket in ESOARS, it will do so only on a best-efforts basis attempting to cross trades between holders who wish to sell and investors who wish to buy, and for large holders, it will run an auction if they wish.[25] This is a far cry from what is needed: a market-maker who stands continually ready to buy and sell within a limited spread.

Without an adequate secondary market, for this diminutive auction there is no objective market-based way to judge whether the initial sale price really is a fair estimate of the cost of issuing the ESOs, rather than a one-time, limited-size sacrificial sale meant to create the façade of a market for reporting purposes. The failure of Zions to support a market in the security after the auction is consistent with this interpretation; typically when companies issue warrants they promise to make a secondary market in them to increase their attractiveness to investors. If Zions truly believed that the auction produced the right price, then they would be willing to stand as or enlist a market-maker in the security and sell or purchase large amounts with a modest bid-ask spread. Alternatively, Zions should seek offers in the market, rather than bids as we will describe below.

Buyers' and Seller's Incentives

Some of the ideas expressed in the press, which at first seem only peripherally related to ESOARS effectiveness in price-discovery, come into play in discussion of the instrument. These press stories, including several which Zions chose to file with the SEC, have made much of comments surrounding Zions' motives behind their own issuance and their further intention to derive fees from advising other companies who wish to follow suit. According to some reports, interest in the product is expected to hinge on achievement of a lowered expense. Without delving into the accuracy of the

[24] "There may not be an active secondary market for ESOARS; therefore, holders may not be able to find a buyer for their securities or may sell them at a loss," https://www.esoarsauction.com/pma/faq/#is5, 25 March 2007.

[25] Summary, p. 8.

various stories, as we have shown, the ESOARS's auction does result in a lowered reporting expense for FAS123R.

In a typical auction, the buyer obviously prefers a low price while the seller prefers the opposite. A seller striving to minimize the sales price is atypical in the investment world. However, in the ESOARS auction, both seller and buyer appear to desire the same thing, a low price. Avid competitive bidding amongst the buyers is attenuated for the many reasons we have discussed. In such a situation the price will be artificially low.

But regardless of buyer demand, a lower limit is usually determined by the seller's estimate of true value; after all, the seller can withdraw the security rather then sell it at a ridiculously low price. In a standard auction, the seller often establishes a "reservation" price, the lower limit and point of withdrawal. In the ESOARS case, though, the seller like the buyer has an incentive for the price to be low in order to book a low expense for ESOs, and no such lower limit is set. Zions has an incentive to obtain a low valuation for their ESOARS product, and the small size and one-time nature of the issue allows this incentive to take precedence over the desire to maximize the funds raised by the issue's sale, the normal consideration when issuing a security for the purpose of raising capital.

The extent of the downward bias of ESOARS

How downward-biased is the auction price? It is possible to examine the implications of the price in terms of Zions' own disclosures. Use of the Black-Scholes model in this context does not rely on the Black-Scholes model being correct; it only uses the model to translate price into estimates of the inputs that are more readily compared across different securities.

The reported ESOARS auction price was \$7.50.[26] One natural question is what implied volatility would result from this valuation. (In options markets, prices are often thought of in terms of the implied volatility of the option, which traders use as a surrogate by which to compare prices. The implied volatility is the volatility input into the option pricing model so that the resulting price equals the prevailing market price.) Similarly, we could ask what term or expected life would be consistent with the auction price holding other inputs constant.

From Zions' SEC submission,[27] the expected life of their options was 4 years, the annual dividend yield was 2% and the interest rate was about 5%. They used a volatility of 18% per year which is close to both the historical volatility and the current implied volatility in the market. Using the Black-Scholes model, the life of the option on grant date would have to be set at about 2.2 years to recover the auction value of \$7.50, or equivalently, a grant-date value of \$8.57[28] for FAS123R purposes. This is about half of what Zions estimated to be the expected life and it implies that the ESOs which vest 1/3 in each of

[26] June 29, 2006 test auction of ESOARS, https://www.esoarsauction.com/pma/faq/#is5, the results of which were used to determine grant-date value of \$8.57 per ESO.
[27] Summary, p. 17.
[28] Summary, p. 17.

the three years after the grant date would have to be exercised immediately upon vesting. Alternatively, holding other parameters constant, the implied volatility which recovers the auction price is about 10% per year. To put this in perspective, on the auction date, 29 June 2006, only one company in the S&P500 had a volatility lower than 10%.[29] Furthermore, the volatility of the S&P 500 Index itself was over 13%.[30]

In their submission to the Chief Accountant of the SEC, Zions said that "Given the well-publicized criticisms of the Black-Scholes-Merton model, we expected the market value to be somewhat lower than the modeled price and generally are pleased with the pricing obtained in our first-ever ESOARS auction. Over time, the market for ESOARS should grow more efficient."[31] The Black-Scholes-Merton model and lattice models certainly have their failings, but exactly what the deficiencies are that would lead these valuation models to be persistently biased above the appropriate value is not clear. What then, is there about the pricing that Zions finds so pleasing? And what could possibly justify implied assumptions for expected life in the model that are bizarre compared to actual exercise behavior or for a volatility so extreme compared to other stocks'? Zions is correct that the market should grow more efficient over time, but it won't happen without creating the conditions for an actual market to develop, instead of a stunted demand curve artificially met by a single, one-time supplier.

In conclusion, the ESOARS product is too flawed to serve as a reliable valuation tool for FAS 123R purposes. While the tracking security itself is imperfect but not unreasonable, in combination with the auction mechanism and surrounding conditions and incentives, the design serves primarily to produce a predictably downward biased result.

Remedies

1. Increase Issuance and Remove Entry Barriers

One way to remedy the failings of the ESOARS's mechanism and to achieve the goal of market-based valuation for ESOs would be to significantly increase the issuance size, to provide a regular calendar for issuance, and to eliminate the artificial restrictions on bidders and holders of the security. These actions would attract the interest of bidders and put them in a competitive environment where they would be subject to adequate market discipline. An additional benefit of increased size is that it changes the issuer's incentives to the benefit of market efficiency. As the ESOARS auction is currently designed, the issuer has an incentive to achieve a low price because of perceived benefits associated with the reduction of accounting expense. An economically meaningful issue

[29] This information is obtained from Ivolatility.com, a provider of implied volatility data and analyses. In particular Ivolatility.com's calculations of 180-day call implied volatility on June 29, 2006 for the 496 component companies that were available for computational purposes and the S&P Index itself were used. The one component stock that traded at lower than a 10% implied volatility was in the process of being taken over. ZION was actually the 79th lowest implied volatility in Ivolatility.com's calculations with a 19.24% implied volatility on that day, from the market data.

[30] Of the five component stocks that actually traded at lower implied volatilities than the S&P Index itself on that date, only one was not in the process of being taken over or merged.

[31] Summary, p. 18.

size would turn the issuer's attention to raising funds at an attractive price, and, as a further consequence, artificial restrictions on bidders hold much less appeal to that issuer.

Zions does have the capacity to make much larger-scale offerings. As examples of the size of Zions' other transactions, in December 2006 Zions issued $240 million of non-cumulative perpetual preferred stock.[32] Rather than have the tracking security be a fraction of the value of the ESOs, for true price discovery it should be the same or even a multiple of the size of the ESOs.[33] In addition, if the market were assured of a regular calendar of sufficiently large issues, it could further attract the interest of a broad spectrum of potential bidders.

Increased issue size and the elimination of restrictions would attract the attention of a broad spectrum of market participants, a regular calendar would assure them that they could amortize the information and analysis costs of bidding over future auctions, and the elimination of the seller's incentives to achieve a low valuation could assure the buyer that a subsequent call would not be at a significant discount to value. The resulting auction price would be a market-based discovery of the fair value.

2. Provide a Liquid Secondary Market

A complementary remedy would be for Zions to support a liquid secondary market in the security. If Zions were prepared to make a two-sided market in ESOARS available -- providing a market-maker to buy and sell as demanded-- it would alleviate the inability of the current ESOARS auction process to determine a fair value of the ESOs. Currently there is only a one-sided market composed of small positions that must be held for the life of the ESOs or sold in an illiquid secondary market. If ESOARS are correctly valued at the auction price, a market-maker should not mind buying and selling ESOARS at a modest bid-ask spread around the auction price. In this context, the auction is merely a method of initiating a liquid secondary market with a reliable price discovery mechanism. The proper price for expensing would not be the initial auction value but, rather, the prevailing price in the secondary market.

It is common in the financial markets to place more weight on the secondary market price than on the initial offering. Closed-end funds, for example, typically sell in the secondary market at a discount from their net asset value but are sold at a premium in the initial offering. It often takes a few months for the trading price to emerge less its initial premium as the initial buyers of the funds move to sell them in the market. The same would occur for ESOARS (given a liquid secondary market), but in this case it is the initial discount from value that would disappear as buyers entered the market for the bargain values and Zions was in the position of having to raise the price (and provide a sorely-missing supply curve) as it satisfied their demand for significantly larger quantities than were initially offered.

[32] http://www.10kwizard.com, 12/05/2006 filing of 424B3 by Zions Bancorporation.
[33] We realize, of course, that it's highly unlikely that any firm would use ESOARS to raise a major amount of capital.

3. Reverse the Auction

Another simple, complementary remedy using market forces would be to reverse the auction. Instead of selling ESOARS with all of the attendant misalignment of incentives, Zions could buy ESOARS from third party suppliers and use them to hedge the obligation to the employees (or simply hand them over to the employees). The ESOARS payouts would be as they are currently and bidders would compete to supply quantities of options at stipulated prices. Instead of a demand curve, the equilibrium price would be determined by a supply curve (aggregating up from the bottom) from which Zions could purchase. Alternatively, Zions could act as a discriminating monopsonist and simply pay the offer price from each supplier until enough options are accumulated to make the proposed grant to employees. Even at its most inefficient, such a one-sided market would be superior to the current approach, with its misaligned incentives.

FAS 123R requires companies to expense the cost of the ESOs. In the ESOARS auction, bidders offer some estimate of the value to them of receiving the same payments as the employees. If, instead, the company were to buy ESOARS, sellers would agree to supply the payments that the company has to make at an ask price. This ask price is the true cost to the company, i.e., what they have to pay to offset the liability, not the bid price which is what someone is willing to pay to receive the ESOs payouts. In effect, what the Zions ESOARS auction does is find the value of the payouts to financial players, but what is required is the cost to the company of making the payouts. If the auction were sufficiently competitive, the spread between the value of buying the payouts and the cost of supplying them would be very small, but as we have described above, this is not the case with the ESOARS auction. Far more efficient would be to run the auction in reverse to buy ESOARS. Doing so would align the incentives in the usual way, so that the buying company would want a low price and the financial sellers a high price.

Conclusion

In sum, ESOARS require major modifications before they can correctly reflect the true cost to the company of its ESOs. Without remedies or alternatives such as those proposed above, the ESOARS price should not be accepted by auditors nor certified by senior executives as correctly measuring the cost of a company's ESOs.

CVI Personnel

Stephen A. Ross is the CEO of CVI and is currently the Franco Modigliani Professor of Financial Economics at the Sloan School of MIT.

Richard Roll is a principal of CVI and is the Japan Alumni Professor of International Finance at the UCLA Anderson School of Management.

Rick Antle is the COO of CVI and is the William S. Beinecke Professor of Accounting at the Yale School of Management.

Greta Hotopp is a principal of CVI, and holds an MBA from Yale; she was formerly an options trader in the U.S. and the U.K., and headed Barclay's international FX broking desk in Tokyo.

Andrew Jeffrey is a principal of CVI and prior to joining CVI was an assistant professor of finance at the Yale School of Management.

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Via Hand Delivery

February 5, 2007

Conrad Hewitt
Chief Accountant
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Zions Bancorporation ESOARS

Dear Mr. Hewitt:

I am writing on behalf of the Council of Institutional Investors, an association of 140 public, corporate and union pension funds with combined assets of over $3 trillion ("Council"). This letter is in response to the press reports[34] and other information[35] we have been able to obtain about your office's recent approval of Zions Bancorporation's ("Zions") Employee Stock Option Appreciation Rights Securities ("ESOARS") for use as a market-based approach for valuing employee share-based payment awards under Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* ("Statement 123R").

The Council has been, and continues to be, a strong proponent of Statement 123R.[36] We believe Statement 123R improves financial accounting and reporting of share-based payment awards by requiring that, consistent with the Council's corporate governance policies, all employee share-based payment awards be accounted for as compensation costs appropriately reducing reported earnings.[37]

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[34] *SEC approves Zions' stock-option valuation system*, Salt Lake Trib., Jan. 31, 2007; David Reilly and Serena NG, *SEC Clears Market-Based Way To Value Staff Stock Options*, Wall St. J., Jan. 30, 2007, at C5; Matthew Rand, *A Hot New Way to Price Options*, Forbes.com, Jan. 19, 2007.

[35] Press Release, *Zions Bancorporation Receives SEC Clearance for Market-Based Employee Stock Option Valuation Method*, Jan. 30, 2007; Letter from Conrad Hewitt, Chief Accountant, *United States Securities and Exchange Commission*, to James G. Livingston, Vice President, *Zions Bancorporation* (Jan. 25, 2007); Summary prepared by James G. Livingston, Vice President, *Zions Bank*, for the Office of the Chief Accountant, *Securities and Exchange Commission* (Sept. 22, 2006).

[36] *See, e.g.*, Letter from Jeff Mahoney, General Counsel, *Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission* (Jan. 25, 2007), 2 of 4.

[37] *See, e.g.*, Letter from Ann Yerger, Executive Director, *Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission* (June 21, 2007), 3.

We also are a strong proponent of the fair value measurement objective and related implementation guidance contained in Statement 123R. We agree, as stated in that guidance, that "[o]bservable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used as the basis for the measurement of equity and liability instruments awarded in a share-based payment transaction with employees."[38]

We believe your approval of Zions' ESOARS is likely to have a significant impact on the reporting of compensation costs and reported earnings in company financial reports for at least two reasons. First, in addition to using the ESOARS for its own Statement 123R stock option valuation, it appears that Zions plans to actively sell the use of the ESOARS to many other companies for purposes of valuing and reporting share-based payment awards pursuant to Statement 123R.[39] Second, it appears that Zions' experience to-date is that the ESOARS produce a value far below that produced by the well known, and Securities and Exchange Commission ("SEC") staff approved,[40] modified Black-Scholes-Merton model.[41] It has been reported that Zions' vice president has boasted that "companies using Zions' auction system can reasonably expect *to add back as much as half of their options expenses to pretax profits*."[42]

We share your predecessor, Donald T. Nicolaisen's, doubts about the use of market instruments in valuing share-based payment awards when, as appears to be the case for Zions' ESOARS, the "actual transaction price proved to be significantly different from the price that would be expected based on broadly accepted modeling techniques . . . ."[43] In those circumstances, Mr. Nicolaisen concluded that "questions would arise about whether the instrument itself and the marketing of the instrument were sufficient to achieve a true fair value exchange price."[44]

For the reasons stated above, and because your office's decision to approve Zions' ESOARS does not appear to have been subject to any public due process, we would respectfully request that your office defer any further approvals of this approach for a minimum of thirty days. During the thirty day deferral period, the Council and other interested investors would have the opportunity to (1) carefully analyze Zions' ESOARS,

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[38] Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, ¶ A7 (footnote omitted).
[39] *SEC approves Zions' stock-option valuation system* (Reporting that Zions' vice president indicated that the "bank might eventually conduct as many as 50 [ESOARS] auctions a year [for other large companies], charging $200,000 for each one . . . .").
[40] Memorandum from Office of Economic Analysis to Donald Nicolaisen, Chief Accountant, *Economic Perspective on Employee Option Expensing: Valuation and Implementation of FAS 123(R)* (Mar. 18, 2005), 3.
[41] Summary prepared by James G. Livingston, at 17 ("The valuation derived from the auction suggests a value of $8.57 per ESO, which is 68% of the value of $12.65 given by the Black-Scholes-Merton model.").
[42] Matthew Rand, at 1 of 2 (emphasis added). Of note, the reported statement by Zions' vice president is inconsistent with the information contained in Zions' summary prepared for your office.
[43] Donald T. Nicolaisen, Speech by SEC Staff: Statement Regarding Use of Market Instruments in Valuing Employee Stock Options (Sept. 9, 2005), at 2 of 3.
[44] *Id.*

(2) consult with leading valuation and accounting experts, and (3) report to your office any concerns about whether the approach produces sufficiently reliable values for financial reporting purposes.

The ongoing stock option backdating controversy is a constant reminder that the financial accounting and reporting for employee share-based awards is an area in which there is a high risk of intentional misapplication of accounting requirements. Investors, therefore, may not realize the full benefits of Statement 123R unless audit committees, external auditors, the Public Company Accounting Oversight Board, and the SEC, actively support the high quality implementation of Statement 123R's principles-based requirements.

We look forward to your response to our request. Please contact me with any questions or if you need any additional information.

Sincerely,

Jeff Mahoney

Jeff Mahoney
General Counsel

CC: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Kathleen L. Casey
Commissioner Annette L. Nazareth

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Via Email

January 25, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Executive Compensation Disclosure (File Number: S7-03-06)

Dear Ms. Morris:

I am writing on behalf of the Council of Institutional Investors, an association of 140 public, corporate and union pension funds with combined assets of over $3 trillion ("Council"). The Council appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC" or "Commission") interim final rules adopting amendments to the disclosure requirements for executive and director compensation ("Amended Rules"). We, however, must express our disappointment that our comments and the comments of other investors cannot have any practical impact on the Amended Rules applicable to the 2007 proxy statement disclosures because the Amended Rules became effective on December 29, 2006.[45]

We note that the effective date for the Amended Rules was the same date the rules first appeared in the Federal Register, and thirty-one days before the comment period will close.[46] Absent extraordinary circumstances, we believe investors should be provided a meaningful opportunity to comment on significant changes to SEC rules and regulations *before* those changes become effective. The ability for investors to have an opportunity to comment is particularly important when, as discussed further below: (1) investors publicly supported the requirements in the original rule that are now amended; (2) investors did not request the amendments; and (3) the Amended Rules indicate that the Commission has concluded that the amendments will benefit investors.[47]

We acknowledge and appreciate that the Amended Rules require companies to report the full grant fair value of stock and option awards in the year of the grant in a new column added to the Grants of Plan-Based Awards Table.[48] We, however, continue to support the original rule that would have required companies to report the grant date fair value

[45] Executive Compensation Disclosure, Release Nos. 33-8765; 34-55009 (Dec. 29, 2006) [71 FR 78338, 78339] ("Amended Rules").
[46] Id.
[47] Id. at 78340-41.
[48] Id. at 78342.

amounts in the more prominent Summary Compensation Table.[49] The basis for our continuing support of the original rule is set forth in our March 2006 comment letter in response to the SEC's January 2006 proposed rule.[50] Our comment letter states:

> The summary compensation table is an important tool used by investors to gain a "snapshot" of total compensation paid during the year. The Council generally supports the SEC's proposals regarding the table—particularly the disclosure of the full present valuation of stock option awards . . . .
>
> . . . [T]he Summary Compensation Table should disclose the decisions of the compensation committee in the applicable year. Most of the information presented in the proposed columns is consistent with this perspective, including the disclosure of the grant date full fair value for equity instruments, which the Council strongly supports.
>
> . . . .
>
> One of the most important (and long overdue) reforms contained in the proposal is the requirement that companies disclose the full grant date present value of equity instruments. The SEC's proposed approach is appropriate, meaningful, consistent with other disclosures and readily understandable to investors. The Council would oppose eliminating the proposed requirement or weakening it to permit the disclosure of an alternative valuation, such as the amounts expensed under FAS 123R. The proposed methodology is consistent with the objective of providing investors with the tools needed to evaluate the annual decisions of the compensation committee, and it should be retained in the final rule.[51]

The Council has been, and continues to be, a strong proponent of Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (revised 2004) ("Statement 123R").[52] Statement 123R, however, is an accounting standard intended to provide for the appropriate reporting of the cost of employee services received in exchange for an award of equity in a company's statement of earnings.[53] Consistent with the reporting of most other forms of compensation in earnings statements, Statement 123R requires that

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[49] Executive Compensation and Related Disclosure; Final Rule and Proposed Rule, Release Nos. 33-8732A; 34-54302A; IC-27444A (Sept. 8, 2006) [71 FR 53158, 53171-72] ("Original Rule").
[50] Letter from Ann Yerger, Executive Director, Council of Institutional Investors, to Nancy M. Morris, Secretary, Securities and Exchange Commission (Mar. 29, 2006).
[51] Id. at 4-5 app.
[52] See Council of Institutional Investors, 2005 Annual Report 9 (Jan. 2006).
[53] See Statement of Financial Accounting Standards No. 123, ¶ B32 (revised Dec. 2004).

the share-based compensation cost be recognized over the periods during which the employee performs the related services.[54]

In contrast, the original rule's requirements for the Summary Compensation Table were intended to provide for the appropriate reporting of the amount of stock and option awards to certain executives during the reporting period.[55] Consistent with the timing of proxy disclosure of option awards since 1992, the original rule would have required the reporting of the full grant date fair value of the stock and option awards *in the year* of the award.[56]

The original rule acknowledged that the Statement 123R recognition of compensation expense was inconsistent with the purpose of stock and option awards disclosure in the Summary Compensation Table.[57] The original rule explains:

> 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.* If a company does not believe that the full grant date fair value reflects compensation earned, awarded or paid during a fiscal year, it can provide appropriate explanatory disclosure in the accompanying narrative section.[58]

The Amended Rules offer the following two arguments in support of the Commission's "surprise move"[59] to reverse the requirements in the original rule: (1) the new requirements "will better fulfill the Commission's objective of informing investors of current actions regarding plan awards . . . .;"[60] and (2) the new requirements "will be easier for companies to prepare and investors to understand."[61]

With respect to the first argument, as indicated above, we believe, and the SEC initially agreed, that the Commission's objective of informing investors of current actions regarding plan awards is best served by the original rule's requirement that companies

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[54] Id. ¶ B144.
[55] See Original Rule, 71 FR at 53170.
[56] Id. at 53172 (The Original Rule explaining, "[t]he only change [since 1992] is that the awards are now disclosed in dollars rather than number of units or shares").
[57] Id.
[58] Id. (emphasis added).
[59] David B.H. Martin & David H. Engvall, Covington & Burling LLP, SEC Amends Disclosure Rules for Stock-Based Compensation, Securities Client Advisory, Dec. 28, 2006, at 1.
[60] Amended Rules, 71 FR at 78341.
[61] Id.

report the full grant date fair value of executive compensation awards in the Summary Compensation Table. We note that the Amended Rules reference over two dozen investor or investor-based organizations that submitted comment letters generally expressing support for that view.[62] As acknowledged in the Amended Rules, those organizations generally agreed that requiring companies to report the full grant date fair value in the fiscal year of the award in the Summary Compensation Table, "would provide a more complete representation of compensation and would be more consistent with the purpose of executive compensation disclosure."[63]

We also note that the Amended Rules reference eleven organizations that submitted comment letters expressing support for the view taken in the Amended Rules that the Summary Compensation Table should report, "the proportionate amount of an award's total fair value that is recognized in the company's financial statements for the fiscal year."[64] Those eleven organizations include the American Institute of Certified Public Accountants and the Chamber of Commerce of the United States of America, but do not appear to include *a single investor or investor-based organization*.[65]

With respect to the second argument, we believe it is questionable whether the new requirements will make the Summary Compensation Table easier for companies to prepare and investors to understand. The Amended Rules suggest that such benefits will result, at least in part, from aligning the amounts required to be reported in the Summary Compensation Table with the amounts required to be reported by Statement 123R in a company's earnings statement.[66] An analysis by a prominent law firm, however, concludes that the reversal introduces "greater complexity to the rules . . . ."[67] The greater complexity arises, at least in part, because the Amended Rules significantly depart from the Statement 123R requirements by disregarding estimates of forfeitures when computing amounts to be shown in the Summary Compensation Table.[68]

Finally, we note that one implication of the Amended Rules is that the amount for stock and option awards reported in the Summary Compensation Table will generally be less than the aggregate grant date fair value of such awards that would have otherwise been required to be reported under the original rules.[69] Moreover, it appears that the companies that will receive the greatest benefit from the reversal are the more than 800 companies, many in the high technology industry, which accelerated the vesting of

[62] Id. at 78339 n.13.
[63] Id. at 78339.
[64] Id. at 78339-40.
[65] Id. at 78340 n.14. We also note that the Securities and Exchange Commission's then Deputy Chief Accountant, Scott Taub, appeared to acknowledge that the Amended Rules would not result in better information than the Original Rules when he stated: "'I don't think one answer or the other necessarily provides more complete or fuller disclosure—they're just two different ways of providing the information . . . .'" C.E. Rosen, The SEC Stirs the Pot on Executive Comp, CFO.Com, Jan. 4, 2007, at 2 of 3.
[66] See Amended Rules, 71 FR at 78340.
[67] Jeremy L. Goldstein & David E. Kahan, Wachtell, Lipton, Rosen & Katz, SEC Changes Approach to Valuing Equity Awards under Compensation Disclosure Rules, Jan. 3, 2007, at 1.
[68] See David B.H. Martin & David H. Engvall, at 2; Jeremy L. Goldstein & David E. Kahan, at 2.
[69] David B.H. Martin & David H. Engvall, at 4-5.

employee stock options prior to the adoption of Statement 123R.[70] It has been estimated that those companies "dodged" the reporting of more than $4.7 billion in after tax compensation costs in their earnings statements.[71] Those companies will again avoid the reporting of some portion of those costs in the Summary Compensation Table. In commenting on the practice of accelerated vesting of employee stock options prior to the adoption of Statement 123R, a prominent accounting analyst opined:

> Weren't options supposed to "align management interests with those of the shareholders?" That link is broken with accelerated vestings just as surely as it is broken with backdated stock options. . . . And it's an insult added to injury when the supposedly "worthless" options become intrinsically valuable and employee recipients are no longer required to provide services. Some alignment![72]

We appreciate the opportunity to comment on the Amended Rules. Despite the concerns referenced above, we continue to strongly support the Commission's ongoing efforts to update and improve executive compensation disclosures.

Sincerely,

Jeff Mahoney

Jeff Mahoney
General Counsel

[70] See Jack T. Ciesielski, The Analyst's Accounting Observer, Aug. 15, 2006, at 2.
[71] Id.
[72] Id. at 3.

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VIA HAND DELIVERY

September 8, 2006

The Honorable Richard C. Shelby
Committee on Banking, Housing, and Urban Affairs
United States Senate
SD-534 Dirksen Senate Office Building
Washington, D.C. 20510-6075

Re: September 6, 2006, Hearing of the Committee on Banking, Housing, and Urban Affairs on Stock Options Backdating

Dear Mr. Chairman:

I am writing on behalf of the Council of Institutional Investors ("Council"), an association of more than 130 public, corporate and union pension funds with combined assets of over $3 trillion. We applaud your decision to have held the above referenced hearing on a very important and timely issue of great interest to our members in their role as institutional investors. We respectfully request that this letter be made a part of the official hearing record.

The Council believes that executive compensation is a critical and visible aspect of a company's governance. Pay decisions are one of the most direct ways for shareowners to assess the performance of the board. And they have a bottom line effect, not just in terms of dollar amounts, but also by formalizing performance goals for employees, signaling the market and affecting employee morale.

Well designed executive stock compensation programs can lead to superior performance when structured to achieve appropriate long-term objectives and align executives' interests with those of the shareowners. Those programs, however, as evidenced by stock options backdating, can also be abused, undermining the purpose and potential benefits of stock compensation.

We share your view that that stock options backdating "hurts the capital markets . . . [and] destroys confidence in our system."[73] We also appreciate and support your interest in ensuring that the Securities and Exchange Commission ("SEC") has the necessary

[73] Vineeta Anand and Jesse Westbrook, "Congress Wants to Ensure SEC Has Funds to Police Option Awards," Bloomberg.com (September 6, 2006).

resources and authority to address the issues raised by stock options backdating and other potential executive compensation abuses that may arise in the future.

Many of the parties that participated in stock options backdating activities appear to have been motivated by 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 earnings to market participants.

In addition to violating the federal securities laws that were designed to protect investors, stock options backdating activities also appear to have violated a number of the Council's recommended "Corporate Governance Policies," including the following:

> **Performance options**: Stock option prices should be . . . based on the attainment of challenging quantitative goals.
>
> **Stock option expensing**: Since stock options have a cost, companies should include these costs as an expense on their reported income statements and disclose valuation assumptions.
>
> **Grant timing:** Except in extraordinary circumstances, such as a permanent change in performance cycles, long-term incentive awards [including stock compensation] should be granted at the same time each year.
>
> **Award specifics:** Compensation committees should disclose the . . . performance criteria and grant timing of . . . [stock compensation] granted . . . and how each component contributes to long-term performance objectives of a company.

For your information, given our members' significant interest in stock options backdating, in June 2006 the Council sent letters to the 1,500 largest U.S. companies by market capitalization asking those companies to explain: (1) how they granted equity awards; (2) whether they were conducting an internal review of past stock option practices; and (3) whether they were under investigation by the SEC or any other law enforcement agency for stock option-related practices. To-date we have received over 220 responses. The responses are available on the Council's website at www.cii.org. We would welcome the opportunity to share our analysis of the responses with the Committee upon request.

We again want to thank you for holding a hearing on stock options backdating and appreciate the opportunity to provide the Committee with our views on the issue. We look forward to continuing to work with you, Ranking Member Sarbanes, other Members of the Committee, the SEC, and the Public Company Accounting Oversight Board on issues relating to stock option backdating and other issues of importance to our nation's investors.

Sincerely,

Jeff Mahoney

Jeff Mahoney
General Counsel

cc: The Honorable Paul S. Sarbanes, Ranking Member, Committee on Banking, Housing, and Urban Affairs
The Honorable Christopher Cox, Chairman, United States Securities and Exchange Commission
The Honorable Mark W. Olson, Chairman, Public Company Accounting Oversight Board

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June 21, 2006

Nancy M. Morris
Secretary,
Securities and Exchange Commission
100 F Street, NE,
Washington, DC 20549-9303

RE: File Number S7-03-06
Executive Compensation and Related Party Disclosure

Dear Ms. Morris:

I am writing on behalf of the Council of Institutional Investors, an association of more than 140 corporate, union, and public pension plans with more than $3 trillion in assets. The Council requests that the Commission accept this letter as additional comment in response to the Commission's proposed Executive Compensation and Related Party Disclosure rule.

Recent reports regarding stock-option granting practices at some companies have raised significant concern for investors. Concerns center on two major topics: 1) the potential that some stock option grants have been backdated; and 2) the potential that companies may be purposely timing equity grants to take advantage of significant events or news releases that are likely to affect the market value of their stock. We believe the Commission should consider potential amendments to the proposed disclosure rule as well as other disclosures and actions in response to these issues.

The Council recognizes that backdating and grant-timing may not in all circumstances be illegal. However, we strongly believe these practices are inconsistent with the long-term interests of shareowners and obviously can have very significant potential legal ramifications. In each case, we believe these practices are akin to insider trading and very specific disclosures should be required to assist investors in monitoring the behavior of companies in this regard.

Accordingly, we request the Commission consider the following actions:

1) Amend the Executive Compensation and Related Party Disclosure rule proposal to provide the following:

    a) A requirement that companies disclose whether they have adopted a comprehensive policy regarding equity grants. The required disclosure should include specific components of the policy, including grant-date timing, methodologies for establishing strike prices, the roles of responsible parties related to key steps in establishing and administering equity grants, and the basic procedures the company will use to ensure the equity grants are administered in compliance with the policy. The Council believes this policy should address all equity grants to any employees, not just Section 16 officers, but any differences in the treatment of varying classes of employees should be clearly delineated.

b) The date(s) in the preceding year in which the committee approved each equity grant, and the date the grant became effective. Any discrepancy between these dates should be fully explained. The Council continues to support the Commission's proposed disclosure of the grant date for stock or option awards in the Supplemental Annual Compensation Tables.

c) For each equity grant, a requirement that companies provide a brief explanation for the purpose of the award and the grant date of the award. We believe the Commission should require adequate disclosure such that investors will be able to clearly identify situations in which equity grants are made, even if only partially, for the purpose of timing specific events or news, whether specific to the company or otherwise.

2) Review current requirements and enforcement of disclosures related to equity grants made to Section 16 officers. The Council believes the provisions in the Sarbanes-Oxley Act that strengthened the reporting requirements under Section 16(a) of the Exchange Act have likely been an impediment to backdating practices since their implementation in August 2002. Under the new rules, reporting changes in beneficial ownership through a Form 4 filing, including receipt of a grant of stock options, must be done within two business days of receipt of the grant.

   However, it appears that in some instances the Form 4 filings are not being made in a timely manner. According to a recent study,[74] roughly one fifth of a sample of approximately 3,700 option grants between August 2002 and November 2004 violated the two-business-day reporting requirement. Moreover, the study indicated that those grants that were not reported in time were associated with return patterns suggestive of backdating, and the magnitude of the return pattern was greater the longer the delay in reporting. Thus, it appears that, if the two-day reporting requirement is not complied with, the beneficial impact of the requirement as it relates to inhibiting backdating is diminished.

   The Council requests the Commission consider the following actions related to Form 4:

[74] Does backdating explain the stock price pattern around executive stock option grants? Randall A. Heron, Kelley School of Business, Indiana University, and Erik Lie, Henry B. Tippie College of Business, University of Iowa. Paper is forthcoming in the Journal of Financial Economics. JEL classification: J33; M52 Keywords: Executive stock option grants; Backdating.

a) Increased enforcement action and penalties for non-compliance with the current two- business-day filing requirement for Form 4.
b) For each instance in which the filing requirement for Form 4 is violated, require disclosure in the company's proxy statement of the reason for the violation and the status of any action resulting from the violation.

In addition to improved disclosure related to equity granting policies and procedures noted above, the Council believes SEC enforcement action is a critical element of an appropriate response to the backdating scandal. The Council strongly supports the SEC's regulatory actions to date. We believe it is imperative that the Commission investigate fully all instances where there is evidence of backdating and take strong action against all participating parties, including board directors and legal counsel, in those circumstances where improper behavior is discovered. In cases where it is determined fraudulent or misrepresentative disclosures and financial statements occurred, we believe it is appropriate for the

Commission to seek to nullify the related grants or seek restitution of the gains associated with the grants.

Finally, the Council believes that the backdating controversy illustrates that the financial accounting and reporting for employee stock option grants is an area in which there is a high risk of intentional misapplication of the accounting requirements. The Council notes that those companies involved in the backdating controversy appear to have failed to comply with the rules-based exception contained in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("Opinion 25").
The Opinion 25 exception permitted companies for over 30 years to structure their option grants to understate compensation cost and inflate reporting earnings. Financial Accounting Standards Board Statement No. 123R, *Share-Based Payments* ("FAS 123R"), which became effective for most companies on January 1, 2006, replaced the Opinion 25 rules-based exception with a principles-based standard.

FAS 123R improves financial accounting and reporting of stock option grants by requiring that, consistent with the Council's corporate governance policies, all employee stock option grants be accounted for as compensation costs reducing reported earnings. The Council, however, is concerned that some preliminary evidence surrounding the adoption of Statement 123R appears to indicate that some companies may be intentionally understating certain inputs required by the standard in an effort to continue the Opinion 25 practice of understating compensation costs and inflating reported earnings.[75] The Council believes that the benefits of Statement 123R will not be fully realized by investors unless and until the SEC closely monitors and rigorously enforces a high quality implementation of the standard's requirements.

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[75] Jack T. Ciesielski, *The Accounting Analyst's Observer* (May 2, 2006), page 16 (indicating that 81% of companies examined had reduced their volatility input for measuring the cost of employee stock options in 2005).

The Council looks forward to continuing to work with the Commission to improve the quality of information investors receive about executive compensation.

Sincerely,

Ann Yerger

Ann Yerger
Executive Director

CC: The Honorable Richard C. Shelby, Chairman, Committee on Banking, Housing, and Urban
Affairs
The Honorable Paul S. Sarbanes, Ranking Member, Committee on Banking, Housing, and Urban Affairs
The Honorable Michael G. Oxley, Chairman, Committee on Financial Services
The Honorable Barney Frank, Ranking Member, Committee on Financial Services

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March 29, 2006

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303

RE: File Number S7-03-06 Executive Compensation and Related Party Disclosure

Dear Ms Morris:

I am writing on behalf of the Council of Institutional Investors, an association of more than 130 corporate, union, and public pension plans with more than $3 trillion in assets. Council members are long-term investors and leading advocates of good corporate governance practices and requirements.

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 CEOs and other top executives, but also the board processes for setting pay, the disclosure of pay, the structure of pay and the pay-for-performance metrics. Poorly structured pay packages may harm shareowner value by wasting owners' money, diluting ownership and creating inappropriate incentives that may damage a company's long-run performance. Inappropriate pay packages may also suggest a failure in the boardroom, since 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 and industry considerations.

Full and clear disclosure of executive pay 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 thanks the Commission and the staff for preparing this comprehensive proposed rule. The proposal addresses a significant number of the most critical issues to investors, and we urge the Commission to move expeditiously to implement the new disclosure rules in time for the 2007 proxy season.

Overall the Council supports the proposed new format, including the concept of a Compensation Discussion and Analysis, the three primary categories of tables and the supplemental narrative disclosures.

The Council believes that the following elements of the proposal are top priorities and essential to ensure the success of the proposed rule. As summarized below and detailed in Appendix I, the Council recommends strengthening these key elements by modifying certain elements of the proposal.

Compensation Discussion and Analysis (CDA). The qualitative aspects of the disclosure rules are vitally important to Council members, but we recognize they are perhaps the most difficult to define as well as enforce. The Council strongly supports the proposal's concept of the CDA and its integration of principle-based and rules-based approaches.

To strengthen this integrated approach, the Council recommends the SEC expand the list of topics to be discussed "at a minimum" to include: detailed discussions of the rationale behind key components of the executive pay program in general as well as the links to performance contained in the program as a whole and specific to each key element of the program; and disclosure of key pay-related policies, such as "clawback" provisions, ownership/holding requirements, and hedging prohibitions.

We also believe it is essential for the SEC to support this integrated approach by providing detailed guidance (particularly in the first few years) and taking enforcement actions when appropriate.

'Filed' vs. 'Furnished' Status. The Council supports the SEC's proposal to deem the new disclosures "filed" in hopes that the potential for increased scrutiny and potential liability will result in higher quality, more comprehensive disclosures. While the filed status will imply some ownership of the document by the full board and top management, the Council recommends the SEC also make it clear in the final rule that the compensation committee retains ultimate ownership of the disclosures.

Performance Targets and Thresholds. The Council recognizes the sensitive nature of the disclosures of performance targets. Similar to the current disclosure rules, the proposed rule maintains a "safe harbor" under which companies may exclude key information regarding performance targets and thresholds if disclosure may be competitively harmful to the company. The Council believes this approach provides too large an exemption for companies, ultimately leading to lower quality disclosures.

To address this significant weakness, the Council recommends an alternative that would balance company concerns of competitive information while providing details critical for investors to obtain a more complete understanding of compensation plans.

We recommend the SEC require companies to disclose performance targets either: (1) at the time they are established, which would be consistent with the disclosure of other incentive awards such as grant date valuations for equity instruments; or (2) at a future date—such as when the performance related to the award is measured—in cases when companies believe this information is competitively sensitive. If disclosure is postponed, the company should be required to explain that it is taking advantage of this exemption and the basis for taking this action, which would presumably be subject to SEC review.

Summary Compensation Table. The Council strongly supports the disclosure of "total compensation" in the Summary Compensation Table. We believe the elements proposed by the SEC as comprising total compensation are appropriate. In particular, we support the inclusion of the annual increase in actuarial value of pension benefits and the disclosure of the grant date, full fair value of option awards—not the amount expensed under FAS 123. Such disclosures are essential to give investors a full and fair snapshot of executive pay.

To improve the clarity and consistency of the summary compensation table disclosures, the Council recommends the SEC amend column (h), "Non-Stock Incentive Plan Awards," to provide a grant date fair value estimate of the awards instead of the actual earned award value. In our view, the Summary Compensation Table should represent the decisions of the compensation committee during the applicable year. The remaining columns in the proposed Summary Compensation Table are consistent with this approach, and we believe non-stock incentive plan awards also should be presented on this basis. We propose that companies be given direction to calculate these values using probability estimates of achieving the award, discounted to a present value. Disclosure of the methodology and assumptions used by companies to estimate the awards should be required in a footnote. The Council requests that the actual payouts of non-stock incentive plan awards (consistent with the proposed column (h)) be disclosed in the Option Exercise and Stock Vesting Table.

Perquisites. The Council believes the current methodology of using incremental cost to value perquisites and other benefits may significantly understate the value of the benefits. To ensure more accurate disclosures, we recommend changing the current approach to require valuations of perks based on a commercially available equivalent.

The Council supports the proposed thresholds applicable to perks, which we believe strike the appropriate balance between investors' need for complete disclosures and the burden on companies to track minor benefits. To enhance and clarify the presentation of the detailed information, the Council recommends that the SEC require tabular format disclosure of individual perks.

Related-Party Transactions. The Council opposes raising the dollar threshold from $60,000 to $120,000 for disclosure of related-party transactions. The Council has long urged the SEC to enhance the disclosures of related-party transactions between companies, directors and executives. The proposed increase would further weaken an already weak rule, and we urge the Commission to consider amending Regulation S-K as proposed by the Council in its October 1998 rulemaking petition.

Post-Employment Compensation. The Council strongly supports the proposed post-employment compensation disclosures, including the potential payments from retirement plans, nonqualified deferred compensation, and other potential post-employment payments. Post-employment compensation can represent significant value and have a material impact on the overall profile of a compensation program. Disclosures for each named executive officer permit investors to understand the unique nature of the post-employment compensation at any particular company.

We recognize the complexities of disclosures in this area, and we accept that some disclosures will be based on estimates. Therefore, in each of the key areas of post-employment compensation, we support the SEC's proposed rules requiring companies to disclose all material factors related to each plan, particularly the key assumptions and methodologies used for the disclosures.

Performance Graph. The Council believes the new disclosures should retain the performance graph. We do not agree that the information communicated by the graph or its role in the overall compensation disclosure regime is outdated. To the contrary, the graph provides a quick performance comparison in close proximity to the compensation disclosures and is valuable to investors. Further, we believe removing the graph would eliminate a readily accessible and non-controversial source for performance comparisons that shareowners often use in their proposals and other correspondence.

The Council thanks the Commission and its staff for this comprehensive proposal. We value the open dialog the Council has enjoyed with the SEC on this critical issue.

We would be happy to respond if you have any questions or need additional information.

Sincerely,

Ann Yerger

Ann Yerger
Executive Director

Appendix I

Council of Institutional Investors' Response to File No. S7-03-06
Executive Compensation and Related-Party Disclosure

Appendix I is organized consistent with the SEC's proposed rule on executive compensation disclosure and related-party transactions. Each primary section contains the Council's general views on the topic. Bullet points respond to questions posed by the SEC in the release.

Compensation Discussion and Analysis

The Council strongly supports the proposed Compensation Discussion and Analysis (CDA) concept. However, we recommend some amendments to make the approach even stronger.

The Council recognizes that the qualitative nature of the disclosures in the current Compensation Committee Report and the proposed CDA is perhaps one of the most difficult areas for the SEC to define and enforce. Although the current rules established in 1992 emphasized the need for comprehensive qualitative disclosures, the resulting disclosures still are generally viewed as inadequate, which is evidence of this difficulty.

The Council believes the qualitative disclosures in the CDA and the narrative support for specific tables are critical elements of this proposal. To ensure the proper level of qualitative disclosures, we strongly support the proposed approach integrating the strengths of a principle-based approach with some rules-based criteria to ensure specific topics and concepts are discussed in the CDA.

The Council informally surveyed its membership, as well as many executive pay disclosure experts, on the topic of safe harbors in the context of executive compensation disclosure. While the Council is supportive of the SEC's proposal that the new disclosures be deemed "filed," we believe some steps should be taken to ensure the increased liability does not result in more boilerplate language rather than less. One concern is that increased liability related to executive compensation disclosures may result in "over-lawyered" documents in which the individuality and meaning of the disclosures are watered down in an attempt to limit potential liability. Clearly, such an outcome is not the SEC's intent nor will it serve the needs of investors.

We recommend the SEC take the following steps to ensure the CDA disclosures are comprehensive and robust:

1) Continue to emphasize and encourage the comprehensive requirements of the proposed CDA. It is clear in the proposed rule the SEC expects robust, qualitative disclosures, and this emphasis should also be present in the final rule and in any related guidance, enforcement actions, and commentary from the Commission and staff;

2) Continue to provide detailed requirements supplementing the principle-based aspect of the CDA, such as the proposed list of specific topics that must be discussed "at a minimum." The Council recommends the SEC expand the list provided in the proposed rule to include:
   - A greater emphasis on articulating the performance aspects of the overall compensation program, including the company's overall philosophy related to performance and how each component—including employment contracts and severance arrangements—of the program relates to performance and the company's overall compensation objectives, if at all;
   - The company's policy for recapturing incentive pay following specific events such as a restatement in which the "performance" measures affecting a plan are adjusted (clawback provisions)[76]. If the company has no such policy, it should be required to state this fact and explain the reason;
   - Disclosure of any company policy, or lack thereof, regarding the hedging of equity and equity-like positions in the company, including those obtained through the compensation program as well as through other holdings[77].

3) Commit SEC staff resources to evaluating the quality of disclosures under the new rules and providing detailed guidance to companies and to the market as appropriate. The SEC should support the new rules with strict enforcement actions for those companies failing to meet the principle-based requirements of the CDA (as well as other aspects of the new rule); and

4) Consider ways the SEC can ensure compensation committees maintain "ownership" of the compensation disclosures. This could include maintaining the requirement that members of compensation committees include their names under the full reports or in portions thereof.

Disclosure of Performance Target Levels

The Council recognizes the sensitive nature of disclosures related to actual performance targets and thresholds attached to incentive awards granted to executives. Similar to the current disclosure rules, the proposed rule does not require companies to disclose "target levels with respect to specific quantitative or qualitative performance-related factors considered by the compensation committee or the board of directors, or any factors or criteria involving confidential commercial or business information, the disclosure of which would have an adverse effect on the company."

The Council believes this approach provides too great an exemption for companies, resulting in poor quality disclosures. We cannot over emphasize the importance to investors of understanding the overall philosophy behind and drivers of incentive awards granted to top executives. Integral to gaining this type of understanding is the ability to

[76] For a recent example of this type of disclosure, see Pfizer Inc. Preliminary Proxy Statement PRE 14A, filed 2-24-2006, page 52.
[77] For a recent example of this type of disclosure, see Pfizer Inc. Preliminary Proxy PRE 14A, filed 2-24-2006, page 65.

not only understand the types of metrics—such as return on equity, sales growth, or total stock return—to which performance hurdles are tied but also the absolute levels of performance that must be achieved to earn the performance award. This information permits investors to evaluate the potential behavioral characteristics of the awards, the rigor of the targets, the value of the alignment, and the performance of the compensation committee in establishing the incentive program.

There may be some circumstances in which competitive information is embedded within performance plans. We do not believe this is the norm; in most cases, disclosure of performance targets poses no competitive threat to companies.

The Council recommends the SEC require companies to disclose performance targets either: (1) at the time they are established, consistent with the disclosure of other awards such as grant date for equity instruments; or (2) at a future date—such as when the performance related to the award is measured—in cases where companies believe the information is competitively sensitive. If companies postpone disclosure, they should be required to explain that they are taking advantage of the exemption and the basis for taking this action, which would presumably be subject to SEC review as part of the company's filed disclosures.

This compromise approach: 1) provides a balance between investors' need for information and companies' concerns over disclosure of competitive information; 2) helps ensure that companies utilize the exemption in appropriate circumstances and provides for a method of enforcement through SEC oversight; and 3) ensures the compensation committee knows the market will be able to view the hurdles at some point in time, even if only retrospectively.

Performance Graph

The Council believes the new disclosure rule should retain the performance graph. We do not agree the information communicated by the graph or its role in the overall compensation disclosure regime is outdated. The graph provides an easily accessible visual comparison of a company's performance relative to its peers and the market. The rationale expressed in the 1992 rules for placing the graph in close proximity to the narrative disclosure of the company's compensation philosophy remains valid today.

In addition, the graph should be retained because many investors prefer to utilize this source for unquestionable performance comparisons in shareowner proposals and other correspondence. Removing the graph forces investors to utilize other sources or make assumptions in a proposal, which opens a debate that some shareowners would rather avoid.

Compensation Tables

The Council strongly supports the tabular approach for compensation disclosures and the SEC's proposed reorganization of the tables into the three primary categories: 1) compensation within the last fiscal year; 2) holdings of equity-based interests; and 3) retirement and other post-employment compensation. This approach is logical, and we believe the risk of "double counting" of certain types of pay is minimized by the clear delineation between the major components, clear table and column headings, and supporting narrative disclosures. We also believe the SEC should clarify in the final rule that companies should utilize the narrative supporting disclosure to explain what the disclosures mean and provide guidance to avoid the potential for double counting.

Summary Compensation Table

The summary compensation table is an important tool used by investors to gain a "snapshot" of total compensation paid during the year. The Council generally supports the SEC's proposals regarding the table—particularly the disclosure of the total compensation figure and the full present valuation of stock option awards—but recommends a few changes to enhance this important table.

First, the Summary Compensation Table should disclose the decisions of the compensation committee in the applicable year. Most of the information presented in the proposed columns is consistent with this perspective, including the disclosure of the grant date full fair value for equity instruments, which the Council strongly supports. However, the current proposed column (h) for Non-Stock Incentive Plan Compensation would report the value realized during the applicable year for awards established or granted in some previous year. It would be more consistent and more meaningful to investors to alter column (h) so that it provides a grant date estimate of the present value of the non-stock incentive awards made during the year. The Council recommends that companies be directed to calculate these values using probability estimates of achieving the award, discounted to a present value, and be required to disclose the methodology and details of the estimate (similar to the requirements for valuing equity awards). Information related to the realized value of previous years' awards under column (h) is also valuable, and the Council recommends the SEC require disclosure of this amount in another table, perhaps in the Option Exercises and Stock Vesting Table.

Second, the SEC should amend the proposed approach for valuing perquisites to require that it be based on current market prices. We believe the current incremental cost approach is subject to gamesmanship and may significantly understate the true cost of the benefits, particularly relating to transportation benefits, such as company aircraft, and housing benefits. The Council recommends a methodology based on retail prices, including, for example, the retail cost to charter the same model aircraft.

Third, the SEC should expand the items required to be disclosed via tables as opposed to narrative footnotes. In particular, the Council recommends tabular disclosure of individual perquisites and major components of the All Other Compensation column.

The following bullets summarize the Council's responses to questions raised in the release regarding the summary compensation table:

General Comments

- The SEC should maintain the current three-year rolling disclosure format.

- The Council supports the supplemental disclosures accompanying the table (as well as other sections of the proposed rule).

Total Compensation

- The Council strongly supports the proposed requirement that all compensation be disclosed in dollars and that companies provide a total compensation amount. The total pay figure will not only provide meaningful disclosures to investors, it also will help compensation committees understand overall compensation programs and the potential interactions of each element.

Salary and Bonus

- Regarding annual salary and bonus, the Council supports the proposed change to Form 8-K eliminating the disclosure delay when salary or bonus cannot be calculated as of the most recent practicable date. The proposed footnote disclosure in these cases, including the date that the salary and bonus is expected to be determined, should also be included in the final rule.

Stock Awards and Option Awards

- One of the most important (and long overdue) reforms contained in the proposal is the requirement that companies disclose the full grant date present value of equity instruments. The SEC's proposed approach is appropriate, meaningful, consistent with other disclosures and readily understandable to investors. The Council would oppose eliminating the proposed requirement or weakening it to permit the disclosure of an alternative valuation, such as the amounts expensed under FAS 123R. The proposed methodology is consistent with the objective of providing investors with the tools needed to evaluate the annual decisions of the compensation committee, and it should be retained in the final rule.

- The same term assumptions used in computing FAS 123R values for financial statement purposes should be used in executive compensation disclosures to permit efficiency and consistency. However, disclosure of the key valuation assumptions should be provided in close proximity to the equity tables, not simply referenced in the company's financial statements. This information is critical to investors in evaluating the reasonableness of the key assumptions underlying the grant date present value estimate. Several of these assumptions can have a significant impact on the estimated value of option awards.

- The Council supports the elimination of the "potential realizable value" of option grants based on 5 percent and 10 percent increases in value. This disclosure is not as meaningful to investors as the grant date present value.

- The Council supports the SEC's proposal to require disclosure of repriced or otherwise materially modified equity (options and stock appreciation awards) based on the total fair value of the award. Although this methodology differs from the incremental cost basis in FAS 123R, the SEC's approach for the purpose of compensation disclosure is appropriate.

- The Council supports the SEC's proposal to eliminate the current rules giving companies the ability to report performance-based stock awards as incentive plan awards. Requiring consistent disclosure of these awards at the time they are granted is more appropriate and meaningful to investors.

Non-Stock Incentive Plan Compensation

- As noted above, the proposed disclosure of non-stock incentive plan compensation should be amended to require a grant date estimate of the value of the award, similar to the concept behind the other equity columns.

- The Council supports the proposed requirement that all earnings on outstanding equity awards be disclosed. This is more meaningful information to investors than the current requirement that provides disclosure of only above-market or preferential earnings.

All Other Compensation

- The SEC's proposed methodology for the All Other Compensation column is appropriate, as is requiring separate identification of each item exceeding $10,000. This amount is a reasonable balance between the needs of investors for complete disclosure and burdens on companies.

- Given the extent of the disclosures under the All Other Compensation column, the Council recommends the SEC require a supplemental table detailing the various components captured in the column. Tabular disclosure is a much clearer format for these items than a footnote.

- The Council broadly supports the proposed disclosure of deferred compensation and specifically supports disclosing earned compensation, footnoting the amounts deferred, and providing appropriate disclosure under the separate and comprehensive deferred compensation presentation.

- The Council also strongly supports the proposed requirement that companies include the increase in actuarial value of defined benefit and actuarial plans. The SEC's rationale that this information is necessary to permit the presentation of a total compensation figure is accurate.

- The Council requests that the final rule contain the SEC's proposed clear definition and classification of perquisites in an effort to provide ample direction to companies.

- Regarding perquisites, the Council supports the proposed aggregate threshold of $10,000 below which disclosure would not be required. This threshold strikes an appropriate balance between investors' need for complete disclosure and the burden placed on companies. We support the proposed detailed disclosure of any individual perquisites valued at the greater of $25,000 or 10 percent of total perquisites and other personal benefits. In addition, the SEC should require tabular disclosure of individual perquisites; we believe this presentation would be clearer than the proposed footnote list.

- The current and proposed methodology of using incremental cost to value perquisites is flawed and may understate the value of the benefits, therefore, the Council recommends changing the rule to require fair market valuations.

- The Council strongly supports maintaining the current requirement that any tax gross-ups or other reimbursements of taxes owed be separately quantified and identified in the tax reimbursement category. Narrative disclosures related to perquisites should also include a discussion of the tax implications of specific benefits, including whether the benefits are deductible.

Supplemental Annual Compensation Tables

The Council supports the SEC's two proposed Supplemental Annual Compensation Tables. The proposed format provides clear and understandable supplements to the Summary Compensation Table. This information is not too repetitive, nor will it lead to any significant risk of double counting. For this reason, the Council prefers the Supplemental Table approach over the alternative of creating two Summary Compensation Tables.

The following bullets summarize the Council's responses to questions raised in the release regarding the supplemental annual compensation tables:

- The Council strongly supports the proposed delineation between performance-based awards and "all other" awards. This format will enable investors to better evaluate the relative mix of compensation between performance-based and non-performance-based awards.

- As noted above, the Council recommends the SEC amend the format of Column (h) in the Summary Compensation Table to provide an estimate of the grant date fair value of non-stock incentive awards. Such an approach would be consistent with the expanded disclosure of other equity awards. In addition, disclosure of the earned value of non-stock incentive awards should be consistent with the approach in the Option Exercises and Stock Vesting Table.

Narrative Disclosure to Summary Compensation Table and Supplemental Tables

The Council strongly supports the proposed requirement for narrative disclosures supporting the Summary Compensation Table and Supplemental Tables. Clearly, this type of detailed explanation and supporting material is crucial to provide a complete picture of the individual elements of executive pay programs. The SEC must continue to place very strong emphasis on the expectations for complete narrative disclosures in the final rule and in any subsequent guidance, enforcement actions, and commentary from the Commission and its staff.

The following bullets summarize the Council's responses to questions raised in the release regarding narrative disclosure to the summary compensation table and supplemental tables:

- The proposed instructions for the supporting narrative disclosures are sufficiently clear and distinct from the purpose of the CDA, and some overlap between these disclosures is acceptable. It is critical for companies to better explain the philosophy and rationale for: (1) the executive pay program as a whole; and (2) each of the key elements within the program, including how the elements fit together and support the objectives and situation of the company. Some of these points will be relevant in both the CDA and the supporting narrative throughout the disclosures.

- The SEC should amend the proposed rule to include an additional column in the Summary Compensation Table where companies must indicate by checkmark if the individual has an employment agreement.

- The proposed treatment of repricings is a positive step but would be enhanced by quantification and footnote disclosure of the fair value of the award both immediately before and immediately after the repricing or other modification.

Exercises and Holdings of Previously Awarded Equity

Given the size and variety of equity awards granted to executives, the Council has long supported clear disclosure of the potential value of previously awarded equity compensation.

The following bullets summarize the Council's responses to questions raised in the release regarding the disclosure of outstanding equity awards and options exercised/stocks vested:

- The Council supports the proposed format for the Outstanding Equity Awards at Fiscal Year-End Table. Companies should not be required to value out-of-the-money options and stock appreciation rights. However, it would be very useful to investors to require disclosure of the number and key terms of out-of-the-money instruments, since in many cases these instruments may be near their strike price, and regardless, these instruments may have significant impact on an investor's evaluation of the compensation program. This disclosure could easily be accomplished by adding columns for out-of-the-money options and shares/units with footnote disclosure of their key terms.

- The Council supports the SEC's proposal to continue to provide disclosure of awards transferred by an executive. The requirement also should include footnote disclosure of the facts surrounding any transfer, including the identity of the transferee and the relation to the executive. This information is material to investors in evaluating the impact of such a transfer on the alignment and incentive characteristics of the overall plan.

- The Council strongly supports the SEC's proposed format of the Option Exercises and Stock Vested Table. The proposed information in this table is material to investors, and the Council supports the requirement to provide the original grant date fair value of the awards next to the ultimate realized value. Given the supporting disclosure as well as the column heading, this format would not lead to any material risk of double counting. Instead, this table will help investors evaluate the accuracy of companies' estimates and pricing methodologies over time, which the Council views as a significant positive factor. It would not be preferable to combine the proposed Outstanding Equity Awards at Fiscal Year-End Table with the proposed Option Exercise and Stock Vested Table.

- As previously noted, the Council supports the addition to the Option Exercise and Stock Vested Table of realized value under Non-Stock Incentive Plan Compensation. Specifically, the Council requests the Summary Compensation Table column (h), Non-Stock Incentive Plan Compensation, be amended to provide a grant date fair value estimate, similar to other equity tools and that the realized value of non-stock incentive compensation be reported in the Option Exercises and Stock Vested Table.

Post-Employment Compensation

Investor concerns over post-employment compensation have escalated in recent years as these arrangements have exploded in value. Because current disclosure rules in this area are lacking, it is impossible for investors to fully and clearly understand the scope and dollar value of these arrangements. We applaud the SEC for proposing significant revisions to the current rules addressing post-employment compensation.

The following bullets summarize the Council's responses to questions raised in the release regarding the disclosure of post-employment compensation:

Retirement Plan

- The Council supports the SEC's proposed format for the Retirement Plan Potential Annual Payments and Benefits Table, particularly the proposed disclosure based on each NEO and the proposed supplemental narrative description of material factors "necessary to an understanding of each plan disclosed in the table." The examples listed by the SEC in the proposal are appropriate and should be included in the final rule along with a statement that this list is not exhaustive and other material factors should be disclosed as appropriate.

Deferred Compensation

- The Council strongly supports the SEC's proposed tabular and narrative format disclosure of nonqualified deferred compensation. The existing disclosure rules in this area do not provide complete disclosure of relevant compensation and supporting information and thus are in need of significant of revision. Should the SEC require disclosure of all earnings on nonqualified deferred compensation plans as proposed, the Council recommends separate disclosure of any preferential treatment, such as any premium, above-market, or other preferential terms. Earnings on these awards are distinct from other compensation decisions, and the Council believes some investors may treat these values differently from an analytical standpoint.

- The Council supports the proposed footnote quantification indicating the extent to which amounts in the contributions and earnings columns are reported as compensation in the year in question (and other amounts reported in the table under the aggregate balance column were reported in the Summary Compensation Table for prior years) and believes it provides adequate protection against double counting.

- A narrative description of the tax implications for both the participant and the company would be useful information to investors and analysts and should be included with the narrative disclosures accompanying the table.

Other Potential Post-Employment Payments

- The Council strongly supports the SEC's proposal regarding disclosure of Other Potential Post-Employment Payments. These arrangements may vary significantly and often involve significant value and consequences on the alignment and incentive characteristics of the overall compensation program. It is critical for the SEC to require detailed qualitative disclosure regarding the specific mechanics of the plan(s) as well as the rationale and justification supporting their use. The examples of narrative disclosures provided by the SEC in the proposal are appropriate and should be provided in the final rule, particularly the disclosure of tax gross-up payments. The Council suggests the SEC specifically permit tabular disclosure as appropriate in this area, but recognizes that due to the variation in plans, no single format may fit[78]. The Council believes that regardless of the formats used in this section, the final rule should strongly emphasize complete qualitative disclosure.

[78] For a recent example of tabular disclosure providing estimated current values of change in control benefits, see Pfizer Inc. Preliminary Proxy Statement PRE 14A, filed 2-24-2006, page 72.

- The Council understands the quantitative disclosures under the Potential Post-Employment Payments section will necessarily be based on estimates. Nonetheless, investors value this information, because the potential realizable values and the underlying mechanics are key to understanding the complexities of the whole compensation plan. The SEC should emphasize complete disclosure of the assumptions underlying the estimated payments disclosed in this section.

Covered Officers

The following bullets summarize the Council's responses to questions raised in the release regarding the disclosure of covered officers:

- The Council supports the SEC's proposal that the Principal Executive Officer (PEO) and Principal Financial Officer (PFO) with the three other most highly compensated executive officers constitute the Named Executive Officers (NEO). The addition of the Principal Financial Officer to automatic NEO status is appropriate given the role of this position under the requirements of the Sarbanes-Oxley Act in certifying the financial statements and the general importance of this position in the capital structure decisions of public companies.

- The Council supports the SEC's proposed standard of basing NEO status for the three other executive positions on total compensation. The current standard of basing this classification on salary and bonus alone has the potential to miss significant forms of compensation, thus not capturing the highest paid executive officers. The Council recognizes the concerns over volatility in NEO status and potential bias to longer-term employees that may be caused by utilizing total compensation as the standard for NEO status. However, this concern is mitigated by a number of factors: 1) the primary positions of PEO and PFO are locked into NEO status, providing some stability in the disclosures; 2) NEO status is limited to the executive officer team, which is already a somewhat limited group; 3) the focus on total compensation is more representative of companies' decisions and emphasis in their compensation plans (in other words, volatility in the classification of NEO status may in itself be an indicator of how a company views and implements its compensation program); and 4) it is more consistent with the SEC's overall focus on total compensation.

- The final rule should retain the current requirement providing disclosure for up to two additional individuals for whom disclosure would have been required but for the fact that they were no longer serving as executive officers at the end of the year.

- The Council supports the proposal to exclude payments attributable to overseas assignments from the determination of most highly compensated officers as proposed. Other exemptions based on "not recurring and unlikely to continue" compensation should be eliminated

- The proposed threshold of $100,000 total compensation for disclosure of Named Executive Officers appears reasonable.

Interplay of Items 402 and 404

The Council supports the SEC's proposal to clarify the interplay between Sections 402 and 404. In particular, we support the consolidation of disclosures regarding compensation items under Section 402, and we agree with the SEC's rationale that the "possibility of additional disclosure in the context of each of the respective items is preferable to the possibility that compensation is not properly and fully disclosed under Item 402."

Compensation of Directors

In recent years, director compensation has grown more complex. Unfortunately, the disclosure rules have not kept pace with the changes in the director pay arena. As a result, it is difficult for shareowners to determine from narrative disclosures exactly how and how much their elected representatives are paid.

The following bullets summarize the Council's responses to questions raised in the release regarding the disclosure of director compensation:

- The Council supports the proposed tabular format for disclosure of compensation paid to each director. However, these disclosures should be enhanced by providing a three-year rolling format similar to the Summary Compensation Table rather than just a single-year format. The All Other Compensation column should be supported by footnote or expanded tabular disclosure of the individual items under this heading.

- The Council requests that the SEC require narrative disclosure of the rationale, purpose and philosophy of the director compensation program. This emphasis should be similar to the proposed CDA that is related to the executive compensation program, but it should be included with the Director Compensation Table (separate from the CDA).

- The proposed de minimis exception of $10,000 for the disclosure of perquisites and other personal benefits is appropriate and consistent with the proposed rules for executive compensation disclosure.

- The Council recommends specific footnote disclosure or supplemental tables similar to the Outstanding Equity Awards Table and Option Exercise and Stock Vesting Table because they would provide meaningful enhancement to the director compensation disclosure rules. Given the significant importance of equity in director compensation plans, this type of disclosure would permit investors to evaluate overall levels of alignment better than the proposed summary table alone.

Treatment of Specific Types of Issuers

The Council recognizes that small businesses have fewer resources available to meet the proposed executive compensation disclosure requirements. However, the sweeping exemptions for small businesses proposed in the current draft go too far and will result in poor quality disclosures. As a general rule, the Council believes that special exceptions for small businesses, while well-intentioned, ultimately are a disservice to the public markets and to the businesses themselves.

In the case of executive compensation disclosures, the proposal would exempt small businesses from such critical elements of the disclosure rules as the comprehensive qualitative descriptions of the plan (including the CDA), Option Exercises and Stock Vested Table, and Post-Employment Compensation. The Council does not support such significant exemptions for small business in the critical area of executive compensation disclosures. The proposed exemptions would adversely affect the ability of investors to evaluate the merits of compensation structures at these companies and reduce the comparability of disclosures among small companies.

Beneficial Ownership Disclosure

The Council supports the proposed amendment to Item 403(b) to require footnote disclosure of the number of shares pledged as security by NEOs. These circumstances have the potential to influence management's performance and alignment, and thus, this information is material to investors. The Council supports the SEC's proposal that no specific category of loans be treated differently from any other because the purpose should be to provide complete disclosure of all cases in which shares have been pledged.

Note: The Council also is requesting specific disclosure under the CDA of companies' policy, or lack thereof, regarding the hedging of equity and equity-like positions. The purpose of this request is similar to the justification the SEC proposes for disclosure of pledges: these circumstances have the potential to alter the alignment of the compensation plan and influence behavior.

Certain Relationships and Related Transactions Disclosure

Director independence is an issue of fundamental importance to investors and the U.S. corporate governance model. But assessing a director's independence has long been problematic. Current disclosure rules are dated and weak, and as a result, some very basic, yet material, details about director relationships do not have to be disclosed and cannot be determined readily by shareowners.

To ensure that all interested parties have access to the information needed to assess a director's independence, the Council has submitted over the past decade two rulemaking petitions asking the SEC to require enhanced disclosure of relationships between directors, corporations and corporate executives. The October 1997 petition requested an amendment to paragraph (d) of item 401 of Regulation S-K to require company disclosure of "personal, professional and financial relationships" between directors, companies and top management. Recognizing that personal relationships may be too difficult to depict clearly in regulatory language, the Council amended its petition in October 1998 to require disclosure of "familial, professional and financial relationships."

The 1998 petition includes no de minimis dollar thresholds under which disclosure would not be required. Members of the Council recognize that independent directors do not invariably share a single set of qualities that are not shared by non-independent directors. As a result, given that no clear rule can unerringly describe and distinguish independent directors and that various groups have different approaches for assessing independence, the Council firmly believes the only appropriate solution to this persistent problem is to ensure that companies provide disclosure of <u>any</u> professional, financial and familial relationships betweens companies/executives and directors/relatives. Owners and others may then evaluate this information to make their own decisions about a director's independence.

- The Council opposes raising the initial dollar threshold to $120,000. The proposed increase would eliminate disclosure of certain related-party transactions, such as many of the cases involving the employment of relatives, which investors believe are important.

- The Council supports the SEC's approach to indebtedness (integrating paragraph (c) of Item 404 into paragraph (a)). We believe it is appropriate to treat loans like any other related-party transaction and recognize the exception for "ordinary course loans" by financial institutions.

<u>Procedures for Reporting Related-Person Transactions</u>

The Council supports the proposed requirement for disclosure of the policies and procedures established by the company regarding related-party transactions. This type of information is material to investors, so at a minimum, the disclosures should include: 1) the types of transactions that are covered and the standards to be applied pursuant to the policies; 2) the person(s) on the board or otherwise responsible for applying the policies; 3) whether the policies are in writing and where a complete version can be viewed; and 4) if there are transactions requiring disclosure under 404(a) where a company's policies and procedures did not require review or were not followed (or if any type of exception was granted).

<u>Corporate Governance Disclosure</u>

The Council supports the proposed consolidation of governance disclosures in Item 407. In particular, it will be meaningful for investors to be able to identify the criteria the company utilized for the independence determination, including a description of any transactions, relationships or arrangements not disclosed in Item 404(a) that were nonetheless considered by the board in determining that the applicable independence standards were met. In cases where companies have their own definition of independence that is used to make certifications under this section, the companies also should be required to list the material differences between their definition and that of a national securities exchange (applicable to the company). This will provide an easy reference for comparability purposes.

The Council believes the proposed disclosure requirements regarding compensation consultants (under disclosures related to the process and procedure for the consideration and determination of executive and director compensation) is appropriate.

Treatment of Specific Types of Issuers

The Council recommends that paragraph (b) of Regulation S-K also should be included in Regulation S-B. As the SEC appropriately notes in the proposed rule, information regarding policies and procedures established by the company for related-party transactions is material to investors. The mere fact that a company files under Regulation S-B does not change this fact and should not exclude the company from disclosure of these policies. Presumably, the small business issuer still would have a policy or procedure for addressing these issues, and briefly articulating this policy should not cause a burden.

Plain English Disclosure

The Council strongly supports the proposed Plain English requirements; however, we do not believe that these requirements alone are sufficient to prevent boilerplate disclosures. Rather, these requirements should be viewed as an important component of an integrated approach by the SEC to promote the desired levels of disclosure. Other important components should include such aspects as SEC review and guidance (particularly in the first few years of the new rule), public commentary and support from the Commission and staff, as well as appropriate enforcement action.

The Council supports the broad application of Plain English requirements in the compensation disclosure rules. This requirement does not lead to increased disputes or increased litigation because it does not prohibit clear and complete disclosures of material information (in fact, it promotes this perspective).

Permanent Subcommittee on Investigations
EXHIBIT #1

Executive Stock Option Compensation - Book versus Tax Return Differential For Exercised Stock Options

Company	Total Accounting Expense had FAS 123R been in effect	Total Reported Tax Deduction	Percentage Book/Tax Return Differential
KB Home	$11.5 million	$143.7 million	1249%
Occidental Petroleum	$29.0 million	$352.9 million	1216%
Cisco Systems	$21.1 million	$169.3 million	801%
UnitedHealth	$45.7 million	$317.7 million	695%
Safeway	$6.5 million	$39.4 million	606%
Monster	$6.8 million	$24.0 million	351%
Mercury Interactive	$1.8 million	$4.5 million	249%
Comverse	$8.3 million	$19.5 million	234%
Apple	$87.0 million	$192.4 million	221%
	$217.7 million	$1.26 billion	

Prepared by U.S. Senate Permanent Subcommittee on Investigations using data supplied by specified corporations, June 2007

Permanent Subcommittee on Investigations
EXHIBIT #2

Executive Stock Option Compensation - Book versus Tax Return Differential For Exercised Stock Options

Company	Executive	Options exercised (1)	Total Actual Accounting Expense (2)	Total Accounting Expense had FAS 123R been in effect (3)	Total Reported Tax Deduction (4)	Percentage Book/Tax Return Differential
KB Home	Former CEO	3,161,000	$ -0-	$11,506,000	$143,676,000	1249%
Occidental Petroleum	CEO	12,245,000	$832,000	$29,014,000	$352,895,000	1216%
Cisco Systems	CEO	12,350,000	$ -0-	$21,140,000	$169,282,000	801%
UnitedHealth	Former CEO	9,158,000	$ -0-	$45,685,000	$317,679,000	695%
Safeway	CEO	2,220,000	$ -0-	$6,512,000	$39,443,000	606%
Monster	Former COO	704,581	$ -0-	$6,831,000	$24,001,000	351%
Mercury Interactive (5)	Various	133,450	$ -0-	$1,809,000	$4,508,000	249%
Comverse	Various	1,842,000	$ -0-	$8,346,000	$19,544,000	234%
Apple	Various	13,070,000	$ -0-	$87,034,000	$192,402,000	221%

(1) The Subcommittee examined executive stock options that were exercised by corporate executives in the years 2002 to 2006, except that Apple provided exercises from 1998 to 2006. Number of options is rounded to nearest thousand.

(2) Occidental Petroleum voluntarily started expensing stock option grants in 2005.

(3) Financial Accounting Standard 123R, which requires all corporations to book an expense for stock option compensation, took effect for all fiscal years beginning after June 15, 2005.

(4) Figures are rounded to nearest thousand.

(5) In 2006, Mercury Interactive Incorporated was acquired by Hewlett Packard, and is now a wholly owned subsidiary.

Prepared by U.S. Senate Permanent Subcommittee on Investigations using data supplied by specified corporations, June 2007

KB Home Executive Stock Option Compensation - Book versus Tax Return Differential

Company	Executive	Calendar/Fiscal Year Exercised	Grant Date	Number of Options Exercised	Black Scholes Value	Reported Book Expense	Total Accounting Expense had FAS 123R been in Effect (1)	Total Reported Tax Deduction
KB Home	Former CEO	FY 2004	1/25/1996	32,102	$ 2.349	$ -0-	$ 75,420.00	$ 1,017,425.00
			2/6/1997	67,276	$ 1.816	$ -0-	$ 122,200.00	$ 2,155,086.00
			10/25/1999	751,042	$ 2.778	$ -0-	$ 2,086,094.00	$ 22,385,262.00
							$ 2,283,714.00	$ 25,557,773.00
		FY 2005	12/5/1997	219,648	$ 3.297	$ -0-	$ 724,190.00	$ 8,972,621.00
			5/28/1998	239,356	$ 2.647	$ -0-	$ 633,599.00	$ 9,520,385.00
			12/1/1998	406,048	$ 4.639	$ -0-	$ 1,883,515.00	$ 16,414,491.00
			10/25/1999	45,800	$ 2.778	$ -0-	$ 127,214.00	$ 1,958,866.00
			10/13/2000	1,000,000	$ 3.968	$ -0-	$ 3,968,000.00	$ 54,875,000.00
			10/30/2001	400,000	$ 4.714	$ -0-	$ 1,885,760.00	$ 26,376,883.00
							$ 9,222,278.00	$ 118,118,246.00
Totals				3,161,272		$ -0-	$ 11,505,992.00	$ 143,676,019.00
As of latest SEC proxy, total approximate number of remaining stock options held :				2,509,000				

Permanent Subcommittee on Investigations
EXHIBIT #3

(1) Total Accounting Expense is calculated as if FAS 123R had been in effect at time of stock option grant.

Prepared by U.S. Senate Permanent Subcommittee on Investigations using data supplied by KB Home, June 2007

Occidental Petroleum Stock Option Compensation - Book versus Tax Return Differential

Company	Executive	Calendar/Fiscal Year Exercised	Grant Date	Number of Options Exercised(1)	Black Scholes Value	Reported Book Expense (2)	Total Accounting Expense had FAS 123R been in Effect (3)	Total Reported Tax Deduction
Occidental Petroleum	CEO	2002	4/28/1993	290,910	$ 2.76	$ -0-	$ 801,748.00	$ 777,573.00
		2003	4/29/1994	288,734	$ 2.76	$ -0-	$ 795,751.00	$ 1,621,819.00
		2004	4/27/1995	391,354	$ 2.76	$ -0-	$ 1,078,572.00	$ 4,217,250.00
		2004	7/10/1996	208,646	$ 2.57	$ -0-	$ 535,177.00	$ 2,117,976.00
		2004	7/10/1996	183,150	$ 2.57	$ -0-	$ 469,780.00	$ 1,849,980.00
		2005	7/2/1997	392,120	$ 2.57	$ -0-	$ 1,006,768.00	$ 8,270,066.00
		2005	7/2/1997	224,730	$ 2.57	$ -0-	$ 576,994.00	$ 4,739,702.00
		2005	7/2/1997	54,360	$ 2.57	$ -0-	$ 139,569.00	$ 1,576,282.00
		2005	7/2/1997	53,400	$ 2.57	$ -0-	$ 137,105.00	$ 1,538,660.00
		2005	7/2/1997	20,000	$ 2.57	$ -0-	$ 51,350.00	$ 577,250.00
		2006	7/2/1997	1,247,510	$ 2.57	$ -0-	$ 3,202,982.00	$ 48,543,733.00
		2006	7/8/1998	642,302	$ 2.52	$ -0-	$ 1,619,886.00	$ 24,792,857.00
		2003	2/17/1999	496,760	$ 0.87	$ -0-	$ 429,697.00	$ 5,263,594.00
		2003	2/17/1999	89,800	$ 0.87	$ -0-	$ 77,677.00	$ 952,522.00
		2004	7/14/1999	416,850	$ 1.94	$ -0-	$ 808,689.00	$ 5,018,207.00
		2005	7/14/1999	583,150	$ 1.94	$ -0-	$ 1,131,311.00	$ 13,720,441.00
		2004	7/19/2000	1,170,000	$ 2.27	$ -0-	$ 2,650,050.00	$ 22,068,482.00
		2004	7/19/2000	93,800	$ 2.27	$ -0-	$ 212,457.00	$ 1,766,521.00
		2005	7/19/2000	226,240	$ 2.27	$ -0-	$ 512,434.00	$ 7,140,044.00
		2006	7/11/2001	2,592,518	$ 2.95	$ -0-	$ 7,647,928.00	$ 99,099,001.00
		2006	7/17/2002	1,184,870	$ 2.68	$ 88,207.00	$ 2,956,060.00	$ 45,481,235.00
		2006	7/16/2003	1,393,576	$ 1.60	$ 743,938.00	$ 2,171,910.00	$ 51,764,381.00
Totals				12,244,780		$ 832,145.00	$ 29,013,895.00	$ 352,897,576.00

As of latest SEC proxy, total approximate number of remaining stock options held: 706,424

Permanent Subcommittee on Investigations
EXHIBIT #4

(1) Portions of the 2002 and 2003 grants did not fully vest until after July 1, 2005.
For the options that vested after July 1, 2005, Occidental Petroleum booked an accounting expense.

(2) Occidental Petroleum began voluntarily expensing stock option grants under FAS 123R as of July 1, 2005.

(3) Total Accounting Expense is calculated as if FAS 123R had been in effect at time of stock option grant.

Prepared by U.S. Senate Permanent Subcommittee on Investigations using data supplied by Occidental Petroleum, June 2007

Cisco Systems Executive Stock Option Compensation - Book versus Tax Return Differential

Company	Executive	Fiscal Year Exercised	Grant Date	Number of Options Exercised	Black Scholes Value	Reported Book Expense	Total Accounting Expense had FAS 123R been in Effect (1) (2)	Total Reported Tax Deduction
Cisco Systems	CEO	FY2004	8/16/1995	2,000,000	$ 1.09	$ -0-	$ 2,170,200.00	$ 38,277,709.00
		FY2005	1/23/1996	1,800,000	$ 1.26	$ -0-		
			7/29/1996	2,700,000	$ 1.61	$ -0-		
							$ 6,610,187.00	$ 61,329,110.00
		FY2006	4/28/1997	4,500,000	$ 1.63	$ -0-		
			5/1/1998	1,350,000	$ 3.72	$ -0-		
							$ 12,359,702.00	$ 69,674,752.00
Totals				12,350,000		$ -0-	$ 21,140,089.00	$ 169,281,571.00
As of latest SEC proxy, total approximate number of remaining stock options held:				29,850,000				

(1) Total Accounting Expense is calculated as if FAS 123R had been in effect at time of stock option grant.

(2) An additional expense of approximately $139 million would have been incurred for options currently "underwater." These options will expire within the next 18 months. Because the options are "underwater" and not expected to be exercised, no tax deduction is anticipated for these options.

Permanent Subcommittee on Investigations
EXHIBIT #5

Prepared by U.S. Senate Permanent Subcommittee on Investigations using data supplied by Cisco Systems, June 2007

UnitedHealth Group Executive Stock Option Compensation - Book versus Tax Return Differential

Company	Executive	Calendar/Fiscal Year Exercised	Corrected Grant Date (1)	Number of Options Exercised	Black Scholes Value	Reported Book Expense (4)	Total Accounting Expense had FAS 123R been in Effect(5)	Total Reported Tax Deduction
UnitedHealth	Former CEO	2003	6/7/1995	1,200,000	$ 3.04	$ -0-	$ 3,647,269.00	$ 26,478,000.00
		2003	7/30/1996	2,000,000	$ 2.35	$ -0-	$ 4,703,038.00	$ 44,692,500.00
		2004	2/11/1997	2,000,000	$ 3.35	$ -0-	$ 24,023,619.00	$ 68,881,200.00
		2004	1/27/1998	1,308,000 (2)	$ 3.20	$ -0-	$ 4,191,745.00	$ 45,671,632.00
		2003	1/7/1999	1,920,000	$ 3.32	$ -0-	$ 6,369,717.00	$ 7,537,053.00
		2006						$ 84,963,833.00
		2006	12/16/1999	729,504 (3)	$ 3.77	$ -0-	$ 2,749,249.00	$ 39,454,713.00
Totals				9,157,504		$ -0-	$ 45,684,637.00	$ 317,678,931.00

As of latest SEC proxy, total approximate number of remaining stock options held: 33,262,496

Permanent Subcommittee on Investigations
EXHIBIT #6

(1) Corrected Grant Dates are the corrected measurement dates adopted by UnitedHealth Group in its restatement, as disclosed in its Form 10-K filed March 6, 2007.
(2) The 1/27/1998 grant was for 1,600,000 options, of which 292,000 have not yet been exercised. Book Expense for this grant reflects only the stock options actually exercised.
(3) The 12/16/1999 grant was for 8,000,000 options, of which 7,270,496 have not yet been exercised. Book Expense for this grant reflects only the stock options actually exercised.
(4) Reported Book Expense reflects charges under APB 25, prior to UnitedHealth's restatement.
(5) Total Accounting Expense is calculated as if FAS 123R had been in effect at time of stock option grant.

Prepared by U.S. Senate Permanent Subcommittee on Investigations using data supplied by UnitedHealth, June 2007

Safeway Executive Stock Option Compensation - Book versus Tax Return Differential

Company	Executive	Calendar/Fiscal Year Exercised	Grant Date	Number of Options Exercised	Black Scholes value	Reported Book Expense	Total Accounting Expense had FAS 123R been in Effect (1)	Total Reported Tax Deduction
Safeway	CEO	2004	4/11/1994	1,150,000	$ 3.09	$ -0-	$ 3,549,404.00	$ 17,179,775.00
		2003	4/11/1994	850,000	$ 3.09	$ -0-	$ 2,623,472.00	$ 13,048,875.00
		2002	10/26/1992	220,000	$ 1.54	$ -0-	$ 338,971.00	$ 9,214,150.00
Totals				2,220,000		$ -0-	$ 6,511,847.00	$ 39,442,800.00
As of latest SEC proxy, total approximate number of remaining stock options held:				5,580,000				

Permanent Subcommittee on Investigations
EXHIBIT #7

(1) Total Accounting Expense is calculated as if FAS 123R had been in effect at time of stock option grant.

Prepared by U.S. Senate Permanent Subcommittee on Investigations using data supplied by Safeway, June 2007

Monster Executive Stock Option Compensation - Book versus Tax Return Differential

Company	Executive	Calendar/Fiscal Year Exercised	Grant Date	Number of Options Exercised	Black Scholes Value	Reported Book Expense	Total Accounting Expense had FAS 123R been in Effect (1)	Total Reported Tax Deduction
Monster	COO	2005	01/06/97	133,332	$ 3.15	$ -0-	$ 419,996.00	$ 4,861,911.00
		2005	12/12/97	10,000	$ 3.67	$ -0-	$ 36,700.00	$ 358,232.00
		2005 & 2006	12/09/98	150,000	$ 5.50	$ -0-	$ 825,000.00	$ 4,747,867.00
		2006	08/05/99	400,000	$ 13.39	$ -0-	$ 5,356,000.00	$ 13,806,011.00
		2006	04/04/01	5,000	$ 22.80	$ -0-	$ 114,000.00	$ 151,062.00
		2003	01/24/03	6,249	$ 6.37	$ -0-	$ 79,625.00	$ 76,147.00
Totals				704,581		$ -0-	$ 6,831,321	$ 24,001,230
As of latest SEC proxy, total approximate number of stock options held:				500,000				

(1) Total Accounting Expense is calculated as if FAS 123R had been in effect at time of stock option grant.

Permanent Subcommittee on Investigations
EXHIBIT #8

Prepared by U.S. Senate Permanent Subcommittee on Investigations using data supplied by Monster, June 2007

Mercury Interactive Executive Stock Option Compensation - Book versus Tax Return Differential

Company (1)	Executive	Calendar/Fiscal Year Exercised	Corrected Grant Date (2)	Number of Options Exercised	Black Scholes Value (3)	Reported Book Expense (4)	Total Accounting Expense had FAS 123R been in Effect (5)	Total Reported Tax Deduction
Mercury Interactive	Director	2004	5/26/1999	20,000	$ 10.68	$ -0-	$ 213,658.00	$ 616,774.00
	Officer	2001	3/9/1998	16,666	$ 6.70	$ -0-	$ 111,679.00	$ 961,045.00
	Officer	2000	6/9/1997	50,000	$ 2.95	$ -0-	$ 147,275.00	$ 2,068,625.00
	Officer	2004	7/15/1999	6,250	$ 8.85	$ -0-	$ 55,332.00	$ 191,834.00
	Officer	2003	7/6/2001	35,792	$ 33.94	$ -0-	$ 1,214,934.00	$ 546,275.00
	Sales Acct Mgr	2005	1/30/2002	683	$ 25.98	$ -0-	$ 17,746.00	$ 6,193.00
	Sales Engineer	2004	1/30/2002	670	$ 25.98	$ -0-	$ 17,408.00	$ 14,386.00
	Sales Acct Mgr	2005	1/30/2002	24	$ 25.98	$ -0-	$ 624.00	$ 229.00
	Application Engineer	2004	7/15/1999	80	$ 8.85	$ -0-	$ 708.00	$ 2,473.00
	VP- Sales	2004	7/15/1999	3,375	$ 8.85	$ -0-	$ 29,879.00	$ 99,892.00
	Totals			133,540		$ -0-	$ 1,809,243.00	$ 4,507,726.00

Permanent Subcommittee on Investigations
EXHIBIT #9

(1) In 2006, Mercury Interactive Incorporated was acquired by Hewlett Packard, and is now a wholly owned subsidiary.
(2) Mercury Interactive misdated some stock option grants. These dates reflect the grant dates that should have been used, according to Mercury Interactive.
(3) Some of the stock options were misdated and were granted with exercise prices that were below the market value at grant date, making them "in the money" options when granted. Mercury Interactive supplied the Black Scholes calculations for these options reflecting their increased values.
(4) Reported Book Expense charges under APB 25, pre Mercury Interactive's restatement.
(5) Total Accounting Expense is calculated as if FAS 123R had been in effect at time of stock option grant. Since Mercury Interactive had been aquired prior to FAS 123R going into effect, FAS 123 was used for calculation purposes.

Prepared by U.S. Senate Permanent Subcommittee on Investigations using data supplied by Mercury Interactive, June 2007

Permanent Subcommittee on Investigations
EXHIBIT #10

Comverse Executive Stock Option Compensation - Book versus Tax Return Differential

Company	Executive	Calendar/Fiscal Year Exercised	Corrected Grant Date (1)	Approximate Number of Options Exercised	Black Scholes Value	Reported Book Expense	Total Accounting Expense had FAS 123R been in Effect (2)	Total Reported Tax Deduction
Comverse	Former CEO	2003	4/12/1995	550,000	$ 3.49	$ -0-	$ 1,917,190.00	$ 7,680,670.00
		2003	9/9/2006	274,740	$ 8.06	$ -0-	$ 2,214,542.00	$ 2,999,019.00
		2003	12/23/2002	324,500	$ 1.74	$ -0-	$ 563,819.00	$ 5,303,214.00
							$ 4,695,551.00	$ 15,982,903.00
	CEO (3)	2003	2/24/1998	37,500	$ 8.95	$ -0-	$ 335,670.00	$ -0-
	foreign subsidiary	2003	10/19/1998	75,000	$ 7.63	$ -0-	$ 572,085.00	$ -0-
		2003	12/23/2002	25,500	$ 1.74	$ -0-	$ 44,306.00	$ -0-
		2003	12/23/2002	76,500	$ 3.11	$ -0-	$ 237,861.00	$ -0-
		2003	12/23/2002	175,500	$ 4.68	$ -0-	$ 820,831.00	$ -0-
							$ 2,010,753.00	$ -0-
	Former CFO	2004	2/24/1998	9,600	$ 8.95	$ -0-	$ 85,932.00	$ 140,192.00
		2003	2/24/1998	28,610	$ 8.95	$ -0-	$ 256,094.00	$ 186,059.00
		2003	10/19/1998	15,000	$ 7.63	$ -0-	$ 114,417.00	$ 103,800.00
		2004	12/23/2002	3,188	$ 1.74	$ -0-	$ 5,539.00	$ 46,226.00
		2005	12/23/2002	1,828	$ 3.11	$ -0-	$ 5,684.00	$ 30,177.00
		2005	12/23/2002	4,239	$ 3.11	$ -0-	$ 13,180.00	$ 69,979.00
		2005	12/23/2002	1,000	$ 4.68	$ -0-	$ 4,677.00	$ 16,508.00
		2005	12/23/2002	8,755	$ 4.68	$ -0-	$ 40,948.00	$ 145,123.00
		2005	12/23/2002	5,296	$ 5.70	$ -0-	$ 30,183.00	$ 87,967.00
		2005	12/23/2002	4,209	$ 5.70	$ -0-	$ 23,988.00	$ 69,911.00
		2003	12/23/2002	48,844	$ 3.11	$ -0-	$ 151,871.00	$ 338,141.00
		2003/2005	12/23/2002	96,744	$ 5.70	$ -0-	$ 551,373.00	$ 1,510,340.00
		2005	12/23/2002	3	$ 5.70	$ -0-	$ 17.00	$ 50.00
		2003/2004	12/23/2002	75,245	$ 4.68	$ -0-	$ 351,928.00	$ 812,316.00
		2005	12/22/2003	382	$ 10.03	$ -0-	$ 3,832.00	$ 3,984.00
							$ 1,639,663.00	$ 3,560,773.00
Totals				1,842,183		$ -0-	$ 8,345,967.00	$ 19,543,676.00

(1) Comverse misdated some stock option grants. These dates reflect the grant dates that should have been used, according to Comverse.
(2) Total Accounting Expense is calculated as if FAS 123R had been in effect at time of stock option grant.
(3) Because this executive is an Israeli employee, Comverse would have incurred an accounting expense for his stock options,
but is barred from claiming any tax deduction for his stock option exercises because he does not have to declare his gains as income for U.S. tax purposes.

Prepared by U.S. Senate Permanent Subcommittee on Investigations using data supplied by Comverse, June 2007

Apple Executive Stock Option Compensation - Book versus Tax Return Differential

Company	Executive	Calendar/Fiscal Year Exercised	Grant Date	Number of Options Exercised	Black Scholes Value	Reported Book Expense	Total Accounting Expense had FAS 123R been in Effect (1) (2)	Total Reported Tax Deduction
Apple	COO	various	2/2/1998	2,800,000	$ 3.95	$ -0-	$ 11,072,320.00	$ 29,260,314.96
		various	3/2/1999	1,200,000	$ 5.24	$ -0-	$ 6,287,280.00	$ 6,276,761.00
		various	1/17/2001	2,000,000	$ 6.15	$ -0-	$ 12,300,200.00	$ 21,772,865.70
				6,000,000			$ 29,659,800.00	$ 57,309,941.66
	Sr. VP, Retail	various	12/14/1999	2,400,000	$ 12.86	$ -0-	$ 30,862,560.00	$ 22,637,586.89
		various	10/26/2000	600,000	$ 6.19	$ -0-	$ 3,714,840.00	$ 9,626,250.00
		various	5/21/2002	600,000	$ 6.02	$ -0-	$ 3,610,800.00	$ 15,646,500.00
				3,600,000			$ 38,188,200.00	$ 47,910,336.89
	CFO	various	7/11/1997	40,000	$ 2.95	$ -0-	$ 118,071.93	$ 425,595.65
		various	7/11/1997	60,000	$ 2.28	$ -0-	$ 137,008.77	$ 638,420.00
		various	7/11/1997	40,000	$ 2.24	$ -0-	$ 89,511.01	$ 425,595.65
		various	12/19/1997	100,000	$ 2.95	$ -0-	$ 295,113.80	$ 837,825.00
		various	12/19/1997	60,000	$ 2.83	$ -0-	$ 169,996.77	$ 502,695.00
		various	12/29/1997	100,000	$ 4.38	$ -0-	$ 438,230.00	$ 851,887.50
		various	8/4/1998	126,672	$ 5.42	$ -0-	$ 686,004.88	$ 2,796,456.89
		various	8/3/1999	440,000	$ 6.56	$ -0-	$ 2,886,224.00	$ 24,660,572.70
		various	10/26/2000	400,000	$ 6.19	$ -0-	$ 2,476,560.00	$ 11,452,968.82
		various	12/14/2001	200,000	$ 5.46	$ -0-	$ 1,091,600.00	$ 8,753,678.18
		various	2/14/2002	200,000	$ 6.27	$ -0-	$ 1,254,440.00	$ 9,012,374.79
				1,766,672			$ 9,642,761.16	$ 60,358,070.17
	Sr. VP, Worldwide Product Marketing	various	7/11/1997	80,000	$ 2.59	$ -0-	$ 207,294.96	$ 1,245,353.68
		various	8/5/1997	80,000	$ 2.60	$ -0-	$ 208,280.00	$ 1,116,603.93
		various	11/5/1997	160,000	$ 2.41	$ -0-	$ 386,272.00	$ 1,700,906.19
		various	8/4/1998	186,668	$ 5.42	$ -0-	$ 1,010,919.22	$ 1,026,996.00
		various	7/6/1999	246,668	$ 5.62	$ -0-	$ 1,387,433.50	$ 2,895,722.72
		various	12/14/1999	150,000	$ 13.61	$ -0-	$ 2,041,695.00	$ 2,313,828.82
		various	10/26/2000	400,000	$ 5.01	$ -0-	$ 2,002,480.00	$ 4,348,207.85
		various	12/14/2001	200,000	$ 5.22	$ -0-	$ 1,044,480.00	$ 6,330,879.27
		various	2/14/2002	200,000	$ 6.27	$ -0-	$ 1,254,440.00	$ 5,845,278.29
				1,703,336		$ -0-	$ 9,543,294.68	$ 26,823,776.74
	Total			13,070,008		$ -0-	$ 87,034,055.84	$ 192,402,125.46

(1) Total Accounting Expense is calculated as if FAS 123R had been in effect at time of stock option grant.
(2) Approximately 55 million options granted to Apple's CEO were cancelled. These options, which had vested, would have resulted in an additional accounting expense of over $570 million, and if exercised, in an additional tax deduction.

Prepared by U.S. Senate Permanent Subcommittee on Investigations using data supplied by Apple, June 2007

Permanent Subcommittee on Investigations
EXHIBIT #11

NOTE TO CHARTS PREPARED BY THE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS STAFF

The preceding charts represent the Subcommittee's effort, with the assistance of the named corporations, to demonstrate the effect of the new accounting rules for stock options in Financial Accounting Statement 123R, which has only recently gone into effect. Because the options exercised in 2006 and prior years (and deducted on the corporate tax returns for those years) were in almost every instance granted in years before FAS 123R was effective, it was not possible to present actual cases in which the book treatment under FAS 123R could be directly compared with the deductions allowed under the Tax Code, and such a direct comparison will not be possible until option grants made in 2005 and 2006 are exercised, in perhaps two or three more years. Accordingly, the Subcommittee asked the identified companies to calculate what the book expense would have been if FAS 123R had been in effect at the time the options recently exercised were granted and to compare those hypothetical book expenses to the tax deductions actually claimed.

Several of the companies who assisted the Subcommittee with these calculations had been involved in the backdating of options during the relevant period and have restated earnings, and will in some instances be filing amended income tax returns. In some instances the amended returns will reduce the compensation deductions taken because the fact the backdated options were "in the money" at the time they were actually granted resulted in the receipt by executives of compensation subject to the $1 million cap of Internal Revenue Code section 162(m). These facts complicated the process of comparing FAS 123R book to tax figures for those companies. In these situations, the Subcommittee requested the corporations to calculate the FAS 123R expense based on the actual date of the stock option grant (the measurement date) and to assume that the strike price was the market price on that date, even if the actual strike price had been set on a different date when the stock price was lower. Using these assumptions, the option grants would be "at the money" and would not have an intrinsic value on that date that would inflate the Black-Scholes value above what the fair value would be in a FAS 123R calculation on a typical option grant. In addition, the grant would have no intrinsic value on that date that would subject any part of the grant to the deduction cap under tax code section 162(m). For this reason, the Subcommittee Staff believes that it is appropriate to compare the calculated FAS 123R expense to the tax deduction originally claimed on the corporate tax return, even though a corporation's restatement of earnings may result in the filing of an amended tax return with different deduction amounts.

Permanent Subcommittee on Investigations

EXHIBIT #12

RESPONSES TO SUPPLEMENTAL QUESTIONS FOR THE RECORD
FROM THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
to
KEVIN M. BROWN
Acting Commissioner
Internal Revenue Service

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON
EXECUTIVE STOCK OPTIONS:
SHOULD THE IRS AND STOCKHOLDERS BE GIVEN DIFFERENT INFORMATION?
June 5, 2007

1. **As soon as the next set of Schedule M-3 data becomes available, will you provide the Subcommittee the same data analysis you performed for the 2004 data?**

   RESPONSE: The Schedule M-3 data is perfected by Statistics Of Income (SOI) division and is available in several versions as it goes through their perfection process. We can provide the first look at this in December 2007.

2. **Will you also provide us with your best estimate of what the revenue effect would be of eliminating the corporate deduction under section 83(h) for corporations covered by the new M-3 data and instead allowing them a new deduction for stock option grants that is tied to the expense reported to shareholders?**

   RESPONSE: The Service does not generate revenue estimates, which are the province of the Joint Committee on Taxation and the Office of Tax Analysis within the Treasury Department. However, we would like to share the following observations:

   i. Before Schedule M-3 came into use for tax years ended on or after December 31, 2004, there was no income tax return line item for stock option deductions that could be compared to financial expenses for stock options. At the same time, there was no FASB requirement to expense stock option costs, and so such expenses were virtually nil.

   ii. In 2004, the first year of use, Schedule M-3 did not require the **amount** of financial statement expense or tax deduction to be reported, only the **difference** between tax deductions and financial expenses. Thus, there is no history of financial statement expense to use for predicting future expenses as FAS 123R

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becomes fully implemented. Correspondingly, if the law were changed to permit future deductions for stock options in the same amount as expensed for financial purposes, data would not be available for several years to predict stock option deduction levels in the future.

iii. When 2005 aggregate Schedule M-3 data is available (see answer to Q1 above), we will be able to report to the Committee Schedule M-3 amounts for stock option expense from financial statements and the total amount of stock option deductions on the relevant tax returns. However, FAS 123R was effective as of the beginning of the first interim or annual reporting period that began after June 15, 2005 for public companies, and December 15, 2005 for small business issuers. Thus, when aggregate 2005 Schedule M-3 data is available, it will not represent data for an entire year with which to make a comparison of financial statement expense and tax deductions for stock options.

iv. It is anticipated that some taxpayers may revise their methods of compensation if they do not have the incentive to use non-qualified stock options provided by the current rules of deductibility. The magnitude of the impact of such changes is not predictable at the present time.

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RESPONSE TO SUPPLEMENTAL QUESTION FOR THE RECORD
FROM THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
to
STEPHEN F. BOLLENBACH
Chairman of the Board of Directors
KB Home

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON
EXECUTIVE STOCK OPTIONS:
SHOULD THE IRS AND STOCKHOLDERS BE GIVEN DIFFERENT INFORMATION?
June 5, 2007

Q. How has FAS 123R affected your company's policies with respect to issuing executive stock options as part of its compensation packages?

RESPONSE: In the time following the adoption of FAS123R, and for a variety of reasons, KB Home has decreased the number of executive stock options being granted as part of its compensation packages. In addition, the company has generally decreased the term of such options from 15 years to 10 years.

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