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The Coalition for American Equity Expansion
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February 1, 1993

TO: Members and Friends of the CAEE

FROM: Ken Hagerty

RE: **Carl Levin Introduces His Anti-Stock Option Bill, and New Coalition Name**

Last Thursday, Senator Carl Levin (D-MI) introduced a new bill, S.259, "The Corporate Executives' Stock Option Accountability Act." to require your company to reduce significantly its reportable earnings.

His bill requires the SEC "to issue regulations requiring publicly traded companies to recognize as an expense in their financial statements the fair value of stock options granted to their employees." The commission is to instruct companies how to calculate the "fair value" of their options. In his statement, though not in the text of his bill, Senator Levin authorizes the commission to make exceptions for "broad-based stock option plans that offer de minimus compensation to all employees." He doesn't suggest how such an exception to GAAP might be possible or why any company would bother with "de minimus compensation."

The Senator misstates as April 1, FASB's current target for publication of its exposure draft (which is "in the second quarter"). He graciously agrees to "delay action" on his bill to allow the "accountants themselves to fix the stock option problem."

As you will see, while he continues to rail against CEO pay, he reinforces one of our important arguments, that the current tax and accounting treatment of stock options forces people to sell their stock when they exercise and reduces stock ownership by employees.

No one should underestimate the threat posed by this bill. Though he could never get it passed through the Banking Committee, Levin can offer it on the floor of the Senate at any time. If he offers it as an amendment to a House-passed bill, it could easily pass the Senate and force us to try to stop it in a Conference Committee. The right strategy is the one we are pursuing of developing a positive alternative and collecting cosponsors. I'll keep you informed.

You may notice we have adopted a new name. ESOFE was fine for defending stock options alone. But since FASB is now attacking employee stock purchase plans as well as options, we are changing our name to reflect our goal of defending and expanding equity compensation in all American companies. "CAEE" is pronounced "key."

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THE CAEE STOCK OPTION REFORM INITIATIVE

Broadbased Stock Option Plans are Endangered

Both the new administration and the new Congress are very likely to propose, and possibly enact, provisions that limit or further tax "executive stock options." When these proposals are combined with the Financial Accounting Standards Board's on-going accounting project to require the value of stock options to be carried as a charge against earnings, many companies could be forced to abandon their broadbased stock option plans.

The Need for a Positive Proposal

Rather than waiting passively for these damaging proposals to emerge, and since the best defense is a good offense, CAEE is developing a legislative initiative *to improve* the current tax and regulatory treatment of employee stock options. We plan to press seriously for its enactment.

With the leadership of companies participating in the coalition, this initiative will allow the business community to combat FASB's damaging proposal and legislative restrictions on stock options such as those proposed by Senator Carl Levin (D-MI). This bill will allow us to educate the press, the new administration and the new Congress on the value of employee stock options in a positive and proactive way.

Companies will be able to help by persuading their constituent House and Senate members to cosponsor the bill. Hearings on this proposal will offer the business community the opportunity to help FASB rethink its proposal by asking them to justify their ideas in open, public sessions.. With enough support, we can persuade FASB to drop its proposal and convince Congress to enact our positive reforms.

Summary of the Campaign

CAEE is developing a menu of legislative and regulatory options for reforming and improving the usefulness of employee stock options. Steering Committee member companies will decide which ideas should be included in the final version we take to Capitol Hill. We will draft a bill and secure a professional estimate of its revenue neutrality. We will then recruit a lead Democratic and Republican sponsor in both the House and Senate.

At that point we will begin publicizing our proposal in the press and seeking association endorsements for the bill. We will also begin meeting with the Administration to educate them on the vital importance of employee stock options. We will publicize the introduction of the House and Senate versions of the bill and mount an aggressive lobbying program that involves all the supporting groups.

Campaign Milestones

I Coalition Recruitment
II Proposal Finalization
III Recruitment of Original House and Senate Sponsors
IV Recruitment of Association Endorsements
V Securing Administration Support
VI Public Unveiling and Introduction
VII Collecting House and Senate Cosponsors
VIII Securing House and Senate Hearings after the FASB Stock Option Exposure Draft has Been Released

Cost

Steering Committee

Companies that lead the development of the proposal, lead our lobbying campaign, and explain the initiative in the press, will contribute $15,000 to the campaign.

Technical Steering Committee

Accounting and law firms with technical expertise will contribute $5,000 to the campaign.

Sponsors

Companies that support this initiative are needed to contact their industry associations and their elected representatives at appropriate points in the campaign. Sponsor companies will receive detailed information on the progress of the initiative and who they should contact throughout the campaign. They will contribute $2,500 to the campaign.

Sponsoring Associations will contribute $2,000.

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Outline of the Proposed
EQUITY EXPANSION ACT OF 1993

A bill to spur the competitiveness and profitability of American companies by promoting broader use of equity compensation for employees at all levels. The bill would reform the current punitive tax and accounting treatment of employee stock options and employee stock purchase plans, while preventing further damaging accounting changes.

The bill leaves existing forms of stock options in place. Companies could continue to offer tax-deductible nonstatutory ("nonqualified") stock options if they wish. But companies willing to forego that deduction would be able to grant their employees a new form of option that requires no taxes at exercise and essentially restores the benefits of capital gains treatment by excluding half of the tax on their gain when they ultimately sell their stock.

Tax Provisions

Despite these powerful tax incentives, this new form of option, called "Performance Share Agreements" (PSAs), will not increase the federal budget deficit. Revenue neutrality is achieved by omitting the employer's expense deduction when PSAs are exercised (as in Incentive Stock Options).

PSA plans require the express approval of the firm's shareholders. They would:

- Relieve employees of any taxable event when they exercise their options. They would still be taxed when they sell their stock.
- Encourage employees to retain their stock after exercise by excluding 50 percent of their eventual gain from tax after a two-year holding period.
- Allow the award of unlimited shares of PSA stock.
- Remove the spread at exercise from the Alternative Minimum Tax, and prevent the IRS from imposing FICA and FUTA taxes on premature sales.

Accounting Provisions

Directs the SEC to end punitive accounting penalties on variable options, thereby providing management with a flexible and powerful new motivational tool. The size of the employee's future grant could be increased or decreased by the achievement of performance goals set by the company (i.e.: shareholder ROI, product development goals, revenue or profitability targets, etc.)

Counters Senator Levin's anti-stock option bill by directing the SEC to maintain the current financial accounting treatment of all forms of fixed employee stock options and stock purchase plans. PSA plans would still appear on the balance sheet and be included in the computation of earnings per share. No compensation charge to earnings would be required. 2-3-93

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WHY WE NEED STOCK OPTION REFORM

By Ken Hagerty

Employee stock options are a vital tool for recruiting, motivating and retaining employees in American companies. Stock options merge the interests of workers and investors. They tie pay to performance and prevent adversarial relationships between labor and management.

Stock options enhance productivity, innovation and shareholder value. They stretch scarce venture capital dollars. Industries that use employee options extensively create more jobs and deliver higher shareholder returns than those that don't.

Contrary to the common public perception, stock options are not just for top corporate executives. A growing number of firms offer them to their entire work force. These broad-based option plans provide a tremendous benefit to mid and lower level employees who could never earn such returns otherwise. *The New York Times* recently reported that Microsoft Corporation alone has created over 2,200 employee millionaires through its stock option and stock purchase programs.

Were it not for a series of government restrictions on stock options, many more American workers would be receiving employee stock options right now. That situation needs to change.

Current Government Policy Stifles Stock Options

American public policy discourages and constrains employee stock options at every opportunity. Tax and accounting restrictions make it difficult and expensive for companies to grant them in the first place. Then when employees later exercise non-statutory options, they are hit with income taxes, and various employment-related taxes.

The tax employees have to pay when they exercise their nonstatutory ("nonqualified") stock options demonstrates how unjust and confiscatory the current treatment of stock options really is.

First, these taxes are triggered by the *purchase* of the stock covered by the option, not its sale. Our income tax system doesn't treat the acquisition of other capital assets as taxable events, yet optionees are taxed when they exercise their options--*before* they have realized any income. (If the value of the stock later plunges before it is sold, the tax man certainly doesn't refund the taxes the employee has already paid!) This isn't an *income* tax transaction at all, it's a confiscatory tax on equity capital. We need to reform this policy.

To add insult to this injury, this tax on employees makes no contribution to easing the deficit or any other public purpose. Every cent of the tax paid is offset by the deduction taken by the employer. (Employees pay at a maximum rate of 33%. Employers then deduct the same gain at their corporate rate of 34%.) This is a wash transaction. It has no point other than to discourage the use of employee stock options. We need to reform this policy.

About the only thing the current tax treatment does efficiently is discourage employees from holding onto their stock. Taxes at exercise, combined with the recent loss of capital gains treatment on stock held for more than a year, now force most employees to sell their stock immediately upon exercise to pay their tax. This defeats the important policy goal of encouraging broader employee ownership in American companies.

Incentive Stock Options Have Been Neutered

In 1981 the American Electronics Association persuaded Congress to enact incentive stock options to redress some of the problems with nonstatutory options. ISOs were designed to allow employees to keep their stock after exercise by relieving them of taxes at exercise. In return for dropping the tax on employees, ISOs provide no deduction for the company. ISOs actually raise money for the Treasury because when they sell their stock, employees pay tax on the full spread from date of grant to the date of sale. Since that tax revenue is not diluted by a deduction, the Treasury comes out ahead.

But over the years, the usefulness of ISOs has been severely curtailed. First they are limited to $100,000. Then, even though they raise money for the Treasury, Congress treats ISOs like a tax concession and imposes an alternative minimum tax and employment taxes. Many employees are forced to sell their ISO stock to pay these taxes. That defeats the whole purpose of the ISO. We need to reform this policy.

Performance-based Option Grants are Penalized

The prospect of earning a larger option grant in the future *could* be a powerful incentive for many employees. Option programs designed to motivate that extra effort *could* be extremely valuable to employers. But instead of encouraging management creativity and employee entrepreneurship, current accounting rules penalize and discourage "variable options." They are little used today because an estimate of their value must be charged against a company's reportable earnings. That last sentence may soon become an epitaph for all types of employee stock options if FASB has its way.

Things Are About to Get Worse

Bad as the current treatment of stock options is, Congressional leaders and the new Clinton Administration have called for even more taxes and deduction limitations on stock option income. At the same time, FASB seems determined to impose a new accounting standard that will make

broad-based employee stock option plans prohibitively expensive in the future.

The Best Defense is a Good Offense

There is just too much at stake here for the business community to allow these threats to go unanswered. We need to take the initiative to reform the treatment of employee stock options in this country. We need to create a public policy climate that encourages rather than stifles broad-based employee stock ownership.

The entrepreneurial culture generated by broad-based employee stock options is one of America's fundamental comparative advantages in the battle for global competitiveness. Our national policy goal should be to strengthen and expand this vital tool, not to let it be destroyed.

No single policy change could do more to stimulate the job-creating technology industries of the U.S. than to encourage, rather than repress, broad-based employee stock options.

CAEE's Stock Option Reform Initiative is The Answer.

CAEE is developing a bill for early introduction in the new Congress to change our policy toward stock options. It will create a new form of option, leaving ISOs and non-statutory options in place.

Because the current treatment of employee stock options is so repressive, it will be possible for CAEE's bill to make major improvements in the tax and accounting treatment of stock options with no additional cost to the Treasury. The bill would:

- Relieve employees of a taxable event at exercise. (They would continue to be taxed when they ultimately sell their stock.)
- Encourage employees to hold their stock after exercise by cutting the taxes they pay when they ultimately sell their stock.
- Allow companies to vary the size of option grants without penalty, based on the attainment of performance goals set by the company.
- Strike stock options from the alternative minimum tax and stop the IRS from imposing FICA and FUTA taxes on premature sales.

CAEE's bill will counter Senator Levin's bill by requiring the SEC to maintain the current accounting treatment of all forms of fixed options and employee stock purchase plans. It will help FASB rethink the political and accounting desirability of the course they are now pursuing.

We hope your company will join CAEE and help us enact these urgently needed reforms.

Draft, 2-5-93