

**Testimony of Linda Thomsen  
Director, Division of Enforcement  
U.S. Securities and Exchange Commission**

**“Executive Compensation and Options Backdating Practices”**

**Before the United States Senate  
Committee on Finance**

**September 6, 2006**

Chairman Grassley, Ranking Member Baucus, and Members of the Committee:

**I. Introduction**

Thank you for inviting me to testify today about the tax aspects of options backdating. I am pleased to testify next to Deputy Attorney General Paul McNulty and IRS Commissioner Mark Everson. While each of us has different law enforcement responsibilities, backdating can impact criminal and tax laws as well as the federal securities laws. Because of this, I want to assure the Committee that the SEC’s Enforcement staff has been sharing information with the Department and the Service as warranted and appropriate. Recently, in fact, the Commission and the Department of Justice jointly announced the filing of two enforcement actions concerning backdating.

Today, I hope to provide the Committee with an understanding of our law enforcement efforts relating to stock options as they, in turn, relate to your interest in overseeing our tax laws. I realize, however, that your interests may go beyond what I, as Director of the Division of Enforcement, can expertly speak to in my testimony, so I am appending a copy of the testimony being given today in the Senate Banking Committee by my Chairman, Chris Cox, also on the issue of options backdating.

**II. Options Backdating Practices**

In a simple stock option, a company grants an employee the right to purchase a specified number of shares of the company’s stock at a specific 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 is awarded at a lower market price, it is said to have been granted “in-the-money.” Typically, an employee cannot exercise the option and acquire the underlying stock until the passing of a specified period of time, known as the vesting period. Options generally vest in equal but staggered amounts—for example, 20 percent per year over five years. Once vested, options generally are exercisable until they expire; however, when an employee leaves a company, he or she generally loses any

unvested options and has only a limited period (such as 90 days) to exercise options that have already vested. Such terms are spelled out in a company's stock plan.

Options became more popular after Section 162(m) of the federal tax laws went into effect in 1993, which limited to \$1 million the tax deductibility of compensation awarded to certain top executives. This change in the tax law tilted compensation practices away from salary and other forms of compensation in favor of performance-based compensation to which the cap didn't apply, such as stock options.

As the use of options compensation has increased, however, so apparently has its abuse. We have learned that some issuers and their executives abused stock option programs by improperly backdating grant dates. The type of "backdating" I'm referring to is the practice of misrepresenting 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 award disguised "in-the-money" options. This allows the option recipient potentially to realize larger eventual gains, but still characterize the options as having been granted "at-the-money."

We have 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 – and at a lower price – than when the exercise actually occurred.

Both of these practices – backdating grants, and backdating option exercises – have tax implications.

#### **A. Backdating Stock Option Grants**

Under the federal tax laws, grants and exercises of stock options can have income tax consequences to companies and individuals alike. Various tax benefits can arise from stock options, and often with more favorable tax treatment afforded to at-the-money option grants as opposed to in-the-money option grants. Backdating option grants can seriously imperil these benefits and potentially result in underpayment of taxes, and associated interest and penalties. These implications are best seen in the context of the two common forms of employee options—non-statutory stock options, or "NSOs", and incentive stock options, or "ISOs".

When an employee exercises a non-statutory option, 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 rates. The company incurs employee withholding obligations on this gain, but also is entitled to an

associated tax deduction on the gain. When companies backdate option grants to a lower exercise price, employees can obtain a larger taxable gain upon the exercise of an NSO and companies can obtain a correspondingly larger tax deduction and withholding obligation on that gain.

Unlike the exercise of NSOs, incentive stock options, or ISOs, afford employees favorable tax treatment because any gain at exercise is not taxed as ordinary income, although the gain may be subject to alternative minimum tax. Accordingly, a company does not obtain any corresponding tax deduction (or incur withholding obligations) at the time of exercise. In addition, if an employee holds the stock for the statutory holding period prior to sale – one year after exercise and two years after grant – then the sale is considered a “qualifying disposition” and the entire gain on sale is taxed at favorable capital gains rates. However, among the statutory requirements of ISOs is that they be granted at-the-money. An ISO that is granted in-the-money loses its favorable status and instead is treated under the tax code as a non-statutory option (NSO), including ordinary income recognition by the employee on any gain at exercise and a corresponding tax deduction by the company on that gain. Backdating allows an employee to treat what is in fact a non-qualified option as an incentive stock option, which can result in the employee underpaying taxes while causing the company to lose the tax deduction to which it otherwise would have been entitled.

Finally, backdating implicates a company’s ability to benefit from tax deductions normally available under Section 162(m) of the tax code. Section 162(m) exempts from its \$1 million tax deduction cap compensation that is performance-based. Compensation an employee obtains as a result of *at-the-money* option grants is considered performance-based under this provision, because the compensation ultimately received is based solely on an increase in the value of the stock after the date of the grant. Thus, Section 162(m) generally entitles companies to a tax deduction for the ordinary compensation income that a named executive officer recognizes upon the exercise of an NSO or upon the disqualifying disposition of an ISO. However, when options are *in-the-money* on their award date, companies lose these tax advantages. Backdating option grants therefore can result in a company unjustly receiving tax deductions it otherwise would not have been entitled to under Section 162(m).

## **B. Backdating Stock Option Exercises**

So far, I’ve focused on the tax implications of backdating stock option grants. But we have also seen that executives have backdated option exercises. This practice benefits employees at the expense of shareholders.

As I mentioned earlier, when an employee exercises a non-statutory stock option (NSO), the employee is required to pay taxes on any gain at the time of exercise, measured by the amount the company’s stock price on the date of exercise

exceeds the exercise price, and the company receives an associated tax deduction on this gain. Thereafter, if the stock obtained through the exercise is then held for at least one year prior to sale, any additional gain to the employee between exercise and sale is treated as a capital gain under the tax laws.

We have seen that employees may backdate exercise dates to correspond with low points of the closing price of a company's stock. In doing so, they are able to minimize the gain at exercise that they report as ordinary income on their tax returns, while maximizing the capital gains treatment of any eventual profits by starting the clock ticking early on the holding period for capital gains treatment. At the same time, the reduced gain at the exercise of an NSO results in a corresponding reduction in the tax deduction for the company.

Similarly, backdating exercise dates of incentive stock options, or ISOs, also starts the holding period early for the favorable long-term capital gains treatment an employee ultimately can receive at the time of a qualifying disposition.

### **III. SEC Enforcement Efforts to Address Backdating Issues**

With this background, let me describe one of our Enforcement cases that more clearly illustrates the fraudulent option practices I have described.

#### Symbol Technologies

In 2004, the Commission levied fraud and other charges concerning option exercises as part of a case that involved various fraudulent accounting practices to overstate revenues or earnings. In this case, the SEC charged Symbol Technologies, Inc. and its former general counsel, Leonard Goldner, with manipulating stock option exercise dates to enable certain senior executives, including Goldner, to profit unfairly at the company's expense. The complaint alleged that rather than use the actual exercise date as defined by Symbol's option plans, Goldner instituted, without board approval or public disclosure, a practice of using a more advantageous date chosen from a 30-day "look-back" period so as to reduce the cost of the exercise to the executive. The SEC charged that, to create the false appearance that these exercises actually occurred on the selected dates, Goldner had his staff backdate the requisite transactional documents and use the phony exercise dates in the forms on which the executives reported their acquisitions to the Commission and the public.

According to the complaint, by backdating the exercise to a date when the company's stock price was lower, the executives obtained a benefit at the shareholders' expense: the executives realized less gain at the date of exercise and thus reduced their tax liability, while the company, among other things, received less of a tax deduction for the exercises (by the same amount of the reduced taxable gain to the executives). The complaint alleged that Goldner's regular use of the fraudulent "look back" practice caused Symbol to misstate its

stock option expenses by material amounts—the company’s restatement of its improper accounting included a cumulative net increase of \$229 million in stock option expenses from 1998 through July 30, 2002. The Department of Justice also filed parallel criminal proceedings against Goldner and another Symbol executive relating to the backdated exercises.

#### Ongoing Investigations

The SEC’s Enforcement Division is currently investigating over 100 companies concerning possible fraudulent reporting of stock option grants. The investigations are being coordinated from our Washington, DC headquarters and are being carried out at our SEC offices nationwide. The companies under investigation are located around the country. They involve Fortune 500 companies and smaller cap issuers. And while a large number of the companies involved are from the technology sector, the companies under investigation span multiple industry sectors.

Because of the importance of these matters and the different laws they implicate, our 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 Internal Revenue Service. We continue to be vigilant on the enforcement front.

#### **IV. Conclusion**

Mr. Chairman, that concludes my testimony. Thank you again for inviting me to appear before you today on this important subject. I am happy to take any questions you may have.