



U.S. SENATE COMMITTEE ON

# Finance

SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN

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## Grassley Takes Aim at Stock Options Backdating, Executive Compensation Tax Loophole

WASHINGTON – Sen. Chuck Grassley today pressed government officials for details on how they are prosecuting the latest corporate scandal of stock options backdating, which enriches top executives at the expense of rank-and-file workers and shareholders. Grassley also said he will continue to review whether the tax policy that apparently encouraged backdating is ripe for change.

Grassley said stock options backdating at some of the nation’s largest companies threatens American values of equal opportunity for economic advancement and fairness. “It is behavior that, to put it bluntly, is disgusting and repulsive,” Grassley said. “It is behavior that ignores the concept of an ‘honest day’s work for an honest day’s pay’ and replaces it with a phrase that we hear all too often today, ‘I’m going to get mine.’ Even worse in this situation, most of the perpetrators had already gotten ‘theirs’ in the form of six- and seven-figure compensation packages of which most working Americans can only dream.”

Grassley, chairman of the Finance Committee, convened a hearing to hear from the Justice Department, the Securities and Exchange Commission, and the Internal Revenue Service about how they are responding to this unfolding scandal and what Congress can do to aid their efforts. The hearing also featured testimony from experts on whether the federal tax treatment of executive compensation is working as intended to discourage excessive executive compensation.

In general, a 1993 law says that for publicly traded corporations, all executive compensation above \$1 million cannot be deducted unless it is performance-based. According to the expert witnesses, many companies have stretched the rules to classify executive compensation as performance-based so they can deduct it, and many executives’ basic salaries exceed \$1 million. All compensation for non-executive employees is generally tax-deductible.

Grassley said the 1993 law, which he did not support, was meant by its advocates to deny tax deductions when there was a great deviation between what executives got paid and what people further down the ladder got paid. “It was well-intentioned,” Grassley said. “But it really hasn’t worked at all. Companies have found it easy to get around the law. It has more holes than Swiss cheese. And it seems to have encouraged the options industry. These sophisticated folks are working with Swiss watch-like devices to game this Swiss cheese-like rule. I want to know what went wrong and consider whether it makes sense to make changes.”

Grassley’s opening and closing statements from today’s hearing follow here.

Opening Statement of Sen. Chuck Grassley, Chairman  
Finance Committee Hearing, "Executive Compensation: Backdating to the Future/Oversight of  
current issues regarding executive compensation including backdating of stock options; and tax  
treatment of executive compensation, retirement and benefits"  
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We all know that the American work ethic is unrivaled anywhere in the world. We have always wanted a better life for our children and our grandchildren. That is a part of our heritage that connects all of us together as Americans. Not only do we work harder than anyone else in the world, we also work smarter. Entrepreneurship, innovation, and technological advancement have been hallmarks of the American economy from our colonial times until today. We remember the spirit of invention of our founding fathers such as Benjamin Franklin and Thomas Jefferson down through the generations to Thomas Edison, Henry Ford, and today's Silicon Valley leaders and pioneers.

It is Americans' work ethic, coupled with our relentless thirst for innovation, that has led us to be the greatest economy that the world has ever seen. The greatness of our economy and our society also rests on some other fundamental principles. We are a capitalist society that believes strongly in the power of free markets to improve standards of living – not just here, but around the world. We believe in the "American dream" – the idea that we all have an opportunity to achieve as much and advance as far as our ability and our work ethic will take us. Underpinning that concept is the idea of fairness – that an honest day's work will mean an honest day's pay. The factory worker who puts in his eight hours (or more in many cases) knows that he will be paid for the hours he works – no more, no less. Similarly, a farmer who has worked hard in his fields all season takes his crop to market and gets paid the market price for that delivery date. He or she doesn't have the option to say, "I want to sell my crops for the price two months earlier when the market was better."

This is the concept of an honest day's work for an honest day's pay in our free market economy. Our capitalist system creates winners and losers, but it is supposed to do so in a way that is fair to all and from which we all ultimately benefit. These are our American values. And we as Americans also believe in the supremacy of the rule of law as the ultimate enforcer of our American values. When anyone threatens our fundamental principles, we must take it very seriously, or risk losing our greatness as a nation.

Today, we will hear about behavior at some of our largest companies that is such a threat. It is behavior that, to put it bluntly, is disgusting and repulsive. It is behavior that ignores the concept of an "honest day's work for an honest day's pay" and replaces it with a phrase that we hear all too often today, "I'm going to get mine." Even worse in this situation, most of the perpetrators had already gotten "theirs" in the form of six- and seven-figure compensation packages of which most working Americans can only dream. But apparently that was not enough for some.

Instead, shareholders and rank-and-file employees were ripped off by senior executives who rigged stock option programs – through a process called "back-dating" – to further enrich themselves. And as we have found far too often in corporate scandals of recent years, boards of directors were either asleep at the switch, or in some cases, willing accomplices themselves. We will hear today from the Justice Department, the SEC, and the IRS about how they are responding to this unfolding scandal and what we as a Congress can do to aid their efforts. We will also hear about executive compensation issues more generally – both from our panel of government witnesses and

from a second panel of experts in the area.

It is important that we defend the American principles of capitalism and free market innovation, and it is also important that we defend the equally important American principles of fairness and the rule of law. These are not conflicting principles. They are the backbone of our nation. And those who violate them need to answer for that.

Closing Statement of Sen. Chuck Grassley, Chairman

Finance Committee Hearing, “Executive Compensation: Backdating to the Future/Oversight of current issues regarding executive compensation including backdating of stock options; and tax treatment of executive compensation, retirement and benefits”

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I thank today’s panelists. This has been a very informative hearing. I am a great believer in conducting oversight of the tax code and we need more of it from the press, GAO and the Inspector General. Clearly, we’ve learned today that 162(m) is broken. The 1993 law – part of a bill that I did not support or vote for, I should make clear – was meant by its advocates to deny tax deductions when there was a great deviation between what executives got paid and what people further down the ladder got paid. It was well-intentioned. But it really hasn’t worked at all. Companies have found it easy to get around the law. It has more holes than Swiss cheese. And it seems to have encouraged the options industry. These sophisticated folks are working with Swiss watch-like devices to game this Swiss cheese-like rule.

I want to know what went wrong and consider whether it makes sense to make changes. Modifying the deduction for performance-based pay or at least tightening up the eligibility are possibilities I think members of the Finance Committee will want to consider based on comments made at this hearing. Today’s hearing is helpful in sorting through the pros and cons of changing the deduction and possible alternatives. It’s challenging for Congress to stay one step ahead of some companies that try to exploit tax loopholes faster than we can close them.

I will be reviewing today’s record, submitted material and questions for the record to consider next steps. If we are going to keep this code section, I think a question that needs to be answered is whether it is equitable to treat high salaries of top executives at publicly traded companies differently than high salaries of other individuals.

We’ve also heard today troubling testimony about the wide disparity of treatment between regular workers and top executives when it comes to deferred compensation, pensions and health insurance. The President’s panel on tax reform touched on some of these same issues as well and they deserve our close attention. Workers who make their living paycheck to paycheck have a right to expect fair tax treatment of their earnings, savings and retirement as compared to the boss.

Finally, I fear that we have a new set of problems behind this backdating – all the individuals who supported this illegal activity. This includes the board members, the attorneys, the accountants and the outside consultants who all either blessed or looked the other way when it comes to backdating.

In response to this hearing, I intend to write to several major corporations that have been involved in the backdating of stock options. I want these corporations to provide me the board minutes regarding the decision to backdate as well as any and all material from advisors – including

attorneys, accountants and compensation consultants who assisted in these efforts. We need to understand and bring enforcement action against all the actors who were involved with this abusive scandal.