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STOCK OPTIONS

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HEARINGS

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

EIGHTY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 1625

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 SO AS TO TERMINATE THE SPECIAL TAX TREATMENT NOW ACCORDED CERTAIN EMPLOYEE STOCK OPTIONS

JULY 20 AND 21, 1961

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ADDITIONAL INFORMATION

STOCK OPTIONS

THURSDAY, JULY 20, 1961

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room 2221, Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd, Kerr, McCarthy, Gore, Talmadge, Williams, Carlson, Curtis, and Hartke.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

The matter before the committee is S. 1625.

(The bill, S. 1625, follows:)

[S. 1625, 87th Cong., 1st sess.]

A BILL To amend the Internal Revenue Code of 1954 so as to terminate the special tax treatment now accorded certain employee stock options

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 421(d)(1) of the Internal Revenue Code of 1954 (relating to definition of restricted stock option) is amended by inserting after "granted after February 26, 1945," the following: "and before April 14, 1961,".

The CHAIRMAN. The first witness is Mr. Michael Waris, Jr., Associate Tax Legislative Counsel of the Treasury Department.

STATEMENT OF MICHAEL WARIS, JR., ASSOCIATE TAX LEGISLATIVE COUNSEL OF THE TREASURY DEPARTMENT; ACCOMPANIED BY STANFORD G. ROSS

Mr. WARIS. I am happy to be here today to present the views of the Treasury Department regarding S. 1625.

To my right is Mr. Stanford G. Ross, a member of the Office of the Tax Legislative Counsel.

This bill, S. 1625, would terminate the tax treatment now accorded to certain employee options by making section 421 inapplicable to options granted after April 13 of this year.

Senator GORE. Before you go any further, you say certain employee options. It relates to restricted stock options, does it not?

Mr. WARIS. That is right, Senator.

Senator GORE. And restricted stock options go to the management employees. I would not want the Treasury Department to give added currency to the term by which this device is justified by some.

Is it correct that what we are speaking of here is the restricted stock

options which are given to a few employees, not the general employees of the corporation?

Mr. WARIS. It is called the restricted stock option, that is true. However, in the law itself there is no requirement that it be given to any specific group either large or small, the discretion is left up to the management.

The statutory treatment of restricted employee options was introduced into the Internal Revenue Code in 1950. The congressional purpose appears to have been primarily to assist corporations in securing better management. This was to be accomplished by facilitating the acquisition by key employees of a proprietary interest in the business.

Senator GORE. Why do you say that the purpose was to assist the corporations to secure better management?

The purpose is plainly set out in the committee report. The purpose was to give tax-free income to those employees to whom restricted stock options were granted.

Is that not the purpose, and is that not the effect?

Mr. WARIS. Senator, we quote here in our statement that portion of the Senate committee report which we thought summarized the congressional purpose most succinctly.

Senator GORE. Let me read you a sentence from the report:

> Under your committee's bill, no tax will be imposed at the time of exercise of a restrictive stock option, or at the time the option is granted, and the gain realized by the sale of the stock acquired through the exercise of the option will be taxed as a long-term capital gain.

And that long-term capital gain would only occur when the stock is sold.

I will let you proceed.

Mr. WARIS. Yes, Senator, that describes the result, the application of the statute.

Senator GORE. You would think a committee would have a purpose of attaining a specific result. Would that not be the purpose of the plan, of the legislation?

Mr. WARIS. That is correct.

That is the result of the operation of the statute.

Now, the purpose as stated in the Senate committee report is, and I quote:

> Such options are frequently used as incentive devices by corporations who wish to attract new management, to convert their officers into "partners" by giving them a stake in the business, to retain the services of executives who might otherwise leave, or to give their employees generally a more direct interest in the success of the corporation.

It is clear that extensive use has been made of section 421 to compensate key corporate employees. In June 1959, Business Week reported that a recent National Industrial Conference Board survey of 673 companies listed on stock exchanges indicated that 69 percent of such companies had such plans at that time. And it is our impression that the number has increased since then.

Section 421 provides a particularly complex scheme for according special treatment. If the option price is at least 95 percent of the fair market value of the stock at the time the option is granted, then no income is realized on the exercise of the option regardless of the fair market value of the stock upon exercise of the option. Thus, a

substantially economic benefit may be obtained, and retained indefinitely, without the payment of any tax. If the stock is sold, then there may be tax, but income realized on the sale of the stock, including that attributable to appreciation prior to the exercise of the option, is taxed as a capital gain. If the stock is held until death, there is no income tax at any time.

Senator GORE. Now, the first category which you discussed there would permit, would it not, a corporate official to receive virtually unlimited income on which he may never pay any tax at all; was that not what you said?

Mr. WARIS. Yes, that is right, Senator.

Senator GORE. Now, I know of instances in which corporate officials have received several million dollars of tax-free income.

Is the Treasury able, are you able, to give some examples of the larger amounts which have been realized as a result of restricted stock options?

Mr. WARIS. I do not have that information available. I could supply it if you would like.

Senator GORE. Mr. Chairman, I would like it for the record.

The CHAIRMAN. It will be furnished for the record.

(The following material was later submitted for the record:)

Example 1.—The ABC corporation granted restricted options to its officers to purchase shares of its stock at $1 a share. (Information as to the date the option was exercised and the value of the stock at such time is not available.) During 1957, one of the officers sold 3,400 shares acquired pursuant to option for a gain of $135,000. During 1958, he sold 20,300 shares for a gain of $900,000. During 1959, he sold 28,300 shares for a gain of $1,700,00.

Example 2.—The DEF corporation granted restricted stock options to its executive employees. During the early years of the plan, the value of the stock of the corporation fell below the option price and the corporation made a corresponding downward adjustment in the option price. During the years 1954–58, one officer of the corporation acquired stock at a cost of about $91,000. (Information as to the value of the stock at such times is not available.) The officer sold the stock in 1960 for approximately $900,000, the resulting gain being $809,000.

Example 3.—The XYZ corporation granted its president a restricted stock option to purchase 50,000 shares. The option was exercised at a cost of $1,703,000 at a time when the stock had a value of approximately $4,500,000, the resulting gain being $2,797,000. (Information as to whether such stock has been sold is not available.)

Senator GORE. Incidentally, many people still say that it is impossible to become a millionaire under present tax laws. This seems to be a well beaten path to multimillions without taxes at all.

Would you agree with that?

Mr. WARIS. As to how well beaten it is—it does have its advantages taxwise, and that is of course the subject of our discussion here today.

Senator GORE. You said a few moments ago that it had widespread use.

Mr. WARIS. There are a number of these plans in effect, it is true.

Senator GORE. If a path is well used, would you say it is well beaten?

Mr. WARIS. I am afraid I have to agree with that statement, yes.

Senator GORE. All right. I just cannot quite understand the caution with which the Treasury is approaching this subject. But you go ahead.

Mr. WARIS. At this point my caution is that this is a highly technical subject, and I like to be sure I am accurate in what I state.

Where the option price is between 85 and 95 percent of the fair market value of the stock at the time the option is granted, a more involved rule becomes applicable.

Senator GORE. I would like to substitute "tenderness" instead of "caution".

Mr. WARIS. No income is realized on the exercise of the option, but the spread between the option price and the fair market value of the stock at the time of grant is taxable as ordinary income on any disposition of the stock, including transfer upon death. In the case of a person who owns more than 10 percent of the stock of his employer, the option price must be at least 110 percent of the fair market value of the stock on the date when the option is granted.

Also, in such a case, the option can be exercised only within a period of 5 years. In cases of employees with lesser stock interests, the option can be exercised over a period of 10 years. In all cases, the benefits cannot be obtained unless the stock is held until at least 2 years after the date the option was granted, and for at least 6 months after the option was exercised.

Section 421 has been the subject of varied criticism, primarily along the following lines.

It has been contended that, in practice, the law discriminates against the closely-held company whose stock is not listed on an established exchange and in favor of the company whose stock is so listed.

The reason is that, in order to qualify under section 421, the option price must be at least 85 or 95 percent of the fair market value of the stock at the time the option is granted. When the stock of a company is not listed on an established exchange, the company ordinarily has great difficulty in establishing with reasonable certainty the fair market value of its stock, and, consequently, unlisted companies are reluctant to use section 421.

On the other hand, companies which are publicly held have no such difficulty. Moreover, it has been asserted that in some instances smaller companies have had difficulty in retaining promising executives because larger companies have induced these executives to join them by offering restricted employee stock options.

A more fundamental criticism of section 421 that has been voiced is that often it has not in fact operated to encourage employees to acquire a proprietary interest in the business—a primary purpose for which the section was enacted.

It has been suggested that in many instances the employee, who has exercised the restricted option, sells the stock so acquired shortly after the minimum holding period. In such situations, section 421 merely provides a way in which compensation can be paid to selected employees without the payment of ordinary income tax thereon and with no possible incentive effect through continued holding of stock.

In this connection, it has been pointed out that in providing other incentive tax benefits in the compensation area, such as pension, profit sharing, and stock bonus plans, Congress has required that the extension of the benefits must be nondiscriminatory—that is, they must be proportionately available to a substantial number of the employees of an enterprise. The benefits of stock options can be bestowed at

will on selected employees, discretion in this regard being unrestricted by section 421.

The basic question raised by S. 1625 is whether this particular form of executive compensation should be accorded special tax treatment. Entirely apart from the above criticisms of the manner in which section 421 has operated, since the preference accorded by section 421 to selected persons is so substantial, both the basic policy objectives of such section and the extent to which they have been realized in actual practice should be reviewed.

If S. 1625 were to be enacted and section 421 repealed, consideration might well have to be given to the bunching of income which might occur if all the compensation involved in an employee option were to be taxed in the year of exercise. This would involve examination of various methods of spreading or averaging such taxable income over an appropriate period of time.

As you know, there are sections already in the law which permit spreading, and the problem may be similar to those dealt with in sections 1301 through 1306 of the Internal Revenue Code.

We plan to consider all the alternatives in the stock option area and had intended to complete our study before next year so that, if changes seem desirable, they could be proposed as part of the program of general tax revision.

In this connection, it should be recognized that, apart from the basic policy questions raised by section 421, there are serious problems of a more technical nature in the stock option area. There is at present considerable controversy as to what rules should govern the taxation of employee options which do not qualify under section 421. Nonqualifying options are on occasion received by employees, although such occurrence normally is not intentional but, rather, is attributable to inability to meet the requirements of section 421.

If section 421 were to be repealed, there might be an even larger group of employee options to be governed by nonstatutory rules. While at one time there was controversy as to whether such options were to be taxed at all, it is now clear, and has at least been clear since the decision of the Supreme Court in 1956 in *Commissioner* v. *LoBue*, 351 U.S. 243, that options granted in connection with the rendition of services are compensatory in nature and subject to tax.

The problem at present is one of determining the time at which options should be taxed—for example, whether on grant, or on exercise, or on sale of the stock acquired pursuant to exercise—and, as a corollary to the timing of the income derived from the option, the amount and type of gain—whether ordinary or capital.

The Treasury Department at one time by regulations sought to provide that options not qualifying under section 421 were not taxable upon grant but were taxable when transferred or exercised, the recipient of the option realizing ordinary income at such time. In several decisions, the courts have refused to uphold such a rule.

In January of this year, the regulations were amended to provide as to employees that an option in certain cases may be taxable upon grant.

There is a substantial administrative problem involved if options are to be taxed upon grant. The value of an option is often very uncertain and difficult to determine. It may be necessary if section 421 were repealed, in order to handle satisfactorily the more technical aspects of

taxing stock options, to enact legislation specifying rules as to the timing and amount of income realized from such options.

To conclude, in addition to the problems of basic policy involved in according employee stock options special treatment, there are problems of a more technical nature which the Treasury is also studying in connection with its review of this area as part of its program of general tax revision.

However, if your committee wishes to develop new legislation this year, we will be pleased to work with you to that end.

The CHAIRMAN. Any questions?

Senator KERR. You say you issued some new regulations in January of this year?

Mr. WARIS. Yes, Senator.

Senator KERR. What was the basis, and what was the substance of the regulations?

Why did you issue them?

Mr. WARIS. Primarily—and I am speaking now without being too familiar with these regulations, not having worked on them—but as I understand it, it was in an effort to clarify some of the rules in the area not covered by 421.

Senator KERR. Not covered by the statute?

Mr. WARIS. Not covered by the statute.

Senator KERR. I see.

Mr. WARIS. Particularly in connection with the valuation of the option——

Senator KERR. If it were an option that did not comply with the statute?

Mr. WARIS. That is correct.

Senator KERR. I got here after you had started.

Does the Treasury take a position at this time with reference to S. 1625?

Mr. WARIS. No, we have no fixed position with respect to this. We realize that there are a number of problems, and that this is an area which merits study.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. No questions.

The CHAIRMAN. Senator Gore.

Senator GORE. Do I correctly understand that the Treasury wishes to defer a recommendation on this subject until next year?

Mr. WARIS. We would prefer to have enough time to give this serious matter adequate study. That would be our preference.

Senator GORE. Six months is not long enough?

Mr. WARIS. Yes, that would be.

Senator GORE. Well, the Secretary of the Treasury has been in office approaching that time, has he not?

Mr. WARIS. Yes.

Senator GORE. I understand the position of the Treasury.

You want to have this as a part, as I understand it, of a tax reform bill next year covering other subjects?

Mr. WARIS. That is correct.

Senator GORE. And because of that you wish to defer the recommendation until next year?

Mr. WARIS. That is correct.

Senator GORE. Well, I am unable to predict whether the Senate will pass a tax bill of limited reform this year. But I am willing to venture the suggestion that any tax reform bill which passes the Senate would include this provision. So I request the Treasury to be preparing from now until the tax reform bill reaches the Senate to give a recommendation on this.

Mr. WARIS. Yes.

I would prefer to have more time, but in view of your statement we will accelerate our study.

Senator GORE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Carlson.

Senator CARLSON. No questions.

The CHAIRMAN. Senator Talmadge.

Senator TALMADGE. No questions.

The CHAIRMAN. Thank you very much.

The next witness is Lewis D. Gilbert of New York.

STATEMENT OF LEWIS D. GILBERT OF NEW YORK

Mr. GILBERT. All that we feared when the Senate enacted the option privileges in 1950 has come to pass. The evidence of mounting abuse continues to increase and will increase unless Congress calls a halt to the special tax treatment now accorded restricted stock options.

When passed, Congress made it clear the objective was to increase proprietary ownership. The way in which most corporations have refused to put in definitive long-term holding periods after exercise proves most conclusively that the objective of proprietary stock ownership—which we would all applaud—is not being attained.

Senator Albert Gore has had the courage to step forward and say, "It is time to call a halt." Both as a shareholder in many corporations and who represents without compensation as a public duty many of his fellow shareholders at annual meetings airing these issues and also as a taxpayer, I have come today to plead with you that Senator Gore's initiative be recognized and enacted by the Congress to prevent the continued erosion of shareholder property in the form of dilution and a needless tax burden being placed on all the rest of us—including the Senators and Congressmen, none of whom get the special treatment allotted top management in the form of stock options.

Let me say at the start that stock options in no way guarantee success. We stockholders put our money down and take the risks, the people who get stock options only exercise them when they are sure things.

Senator GORE. You are referring to restricted stock options?

Mr. GILBERT. I am referring to restricted stock options, sir.

Mr. J. A. Livingston, the great financial editor of the Philadelphia Bulletin, whose column is syndicated in the Washington Post, has asked so rightly:

> Whom do they fundamentally help—the stockholders who will be enriched by the encouragement they afford officers or the officers who will be enriched by the risk-free capital gain profits that stock options offer?

I have said that Congress is being misled if it believes that stock options are creating the proprietary interest it intended to create when the tax advantages were granted.

Let me illustrate some examples:

Take first the Alleghany proxy statement for May 2, 1960's annual meeting, and I have it here if you wish it for the record. Here is what I read, and I quote, and I cite these names purely as examples:

> On March 13, 1959, Mr. Thomas J. Deegan, Jr., a former vice president of the corporation, exercised in full an option to purchase 12,500 shares of the corporation's common stock at $4.375 per share, granted to Mr. Deegan in 1958. The closing market price on the day of exercise was $11.625. As of April 1, 1960, Mr. Deegan was the beneficial owner of 11 shares of the corporation's common stock.

Is this creating proprietary ownership?

Testifying on behalf of stock options before the SEC's Division of Corporate Regulation in 1960, Gwylim A. Price, chairman of Westinghouse, stated: "I own 6,000 shares of Westinghouse Electric stock," and added he had 9,500 share of stock under option.

When the 1960 proxy statement came out, it disclosed that Mr. Price held 1,000 shares of stock. The 1961 proxy statement shows that he has now exercised his options as follows: 6,000 shares at $22 per share; 10,000 shares at $26 per share, and 3,000 shares at $32 on June 27, 1960, on which date such closing price was $59.50.

The proxy statement lists his holdings at 11,050, so that it would appear that he has already sold some of his option stock. And most of that, I am sure, was sold before the episode which brought it down to the forties.

Let us look at another corporation—American Motors—in which I do not happen to be a stockholder.

George Romney sold 10,000 shares in January 1960—why did he sell it?

> I sold the stock primarily to enable me to pay off personal obligations, including indebtedness incurred in purchasing the stock and to finance the purchase as soon as possible legally of enough additional shares * * *.

Again Mr. Livingston commented on this transaction to say, "He had borrowed $200,000 to take up stock options."

Do we wish to encourage this kind of speculation?

As long as the principle Senator Gore is fighting for is not enacted, we will see much of this kind of thing.

Only recently a vice president of the same company sold 7,000 shares of stock—around the same period that he was making a speech before the Detroit Security Analysts on the future of American Motors, as I recall it.

The stock argument which is always used against our pleading for strengthening the requirement that stock options should be held, when we introduce the proposal in the proxy statements, is always, "We have to give options because everyone else is doing it." Again Senator Gore is right—pass his bill ending the special tax advantages and they will no longer have this excuse.

It has also been said that options make an executive stay with a corporation. I maintain this is not so. Let me cite an example.

Some years ago, Avery C. Adams, then head of Pittsburgh Steel, had substantial options there. Did this keep him from exercising them, and then promptly departing from the company? Over he went to Jones & Laughlin and again he had new options from this company.

Bristol-Meyers has options, yet its treasurer went with another corporation where he had family connections, and so on.

Another abuse is now starting to creep into proxy statements.

Formerly options were only granted to full-time executives, but the proxy statements of Fairchild Engine, now Fairchild Stratos, shows us that two directors who are part-time "employees," to use the word in the most generous sense, since one is a lawyer for Mr. Sherman Fairchild and the other a management consultant, are in on the options.

At American Seal Kap, the secretary of the corporation, a prominent lawyer and top-flight partner in the law firm Gallop, Climenko & Gould, is down for his share of the options.

Unless we take some drastic steps to discourage option granting, there will be more and more of this, and I know of no better remedy than the passage of the Gore bill before us.

Another example of the option failing to hold executives is shown by the departure of the general counsel of Standard Oil of Indiana. He has now gone off to United Fruit and again he insisted on a big option there, too.

Nor do options guarantee in any way great achievement. The management of the now bankrupt New York, New Haven & Hartford had options.

William Bloeth, the New York World Telegram financial writer, recently noted in regard to the abuses of stock options:

> The cases are many where the option holder, in order to ante up the necessary cash to exercise the option on the bargain share sold other shares from long holdings and even cases where part of the optioned shares were dumped immediately, all of which puts weight on the issue to the detriment of the ordinary holders who are far, far away from any status where they can get into the game.

I have said that unless corrective action is taken by Congress, this option business will go from bad to worse.

A recent report submitted to Prof. Pearson Hunt's course in financial management at Harvard showed that, whereas in 1954 the number of shares reserved for options in corporations was a median of 4 percent, by 1959 it had already increased to 7 percent, which strengthens our views about public shareholders having the right to be concerned with the ever-increasing, needless dilution of equity.

The White Sewing Machine 1961 proxy statement also had an interesting paragraph which indicates the possibility that, far from helping a corporation and its shareholders, it might actually harm them. Said the statement:

> There is a possibility, which is believed to be a remote one, that the existence of the options might for the life of the options make it more difficult for the corporation to obtain additional working capital by the sale of shares of its common stock in the open market on terms more favorable to the corporation than those provided by the option or on as favorable terms as the corporation might, in the absence of the options, be able to obtain.

Leslie Gould, the financial editor of the New York Journal American, noted in his column of April 17:

> The stock option, an increasing subject of debate at annual stockholders meetings as well as in Washington, is again under attack * * *. Options have become a major fringe benefit for management * * *. Too many of the options are granted with the idea of helping an executive get increased income via the stock market, and thus the practice has become too often a racket * * *.

Referring to the Capital Airlines disaser which ended up in tragedy for the shareholders, he wrote:

The financial difficulties of a major airline partly stem from options which made certain officers, and at least one lawyer-director, stock market minded to such an extent that the company financed with debt instead of equities. They wanted to give leverage to the stock. The result was financial embarrassment and the company had to be taken over.

In an interesting letter to the May–June issue of Harvard Business Review, we have the observations of Emmett Wallace, an associate of the firm of James O. Rice Associates, Inc. He said he had made a year's study of the incentive effect of restricted stock options and had found, after looking at 38 cases of option and nonoption corporations, that there was no statistically significant difference in share price appreciation between the paired firms. He wrote:

While 14 option companies showed performance significantly superior to their mates, 5 did no better and 19 performed significantly worse.

Mr. Rice also noted that the great majority of shares optioned by firms on the New York Stock Exchange had been optioned to senior executives, and he declared:

The mobility of these older executives is low. Options are not necessary to hold them.

I want to thank you for the opportunity to present the views of those shareholders who hope that Congress, by adopting the Gore bill, will put a stop to the dangerous loophole of the special tax treatment for options which we do not consider to be in the interests either of shareholders or taxpayers.

I shall be glad, sir, to answer any questions.

But, with your permission, I would also like to enter into your record the views of Mrs. Wilma Soss, the president of the American Association of Women Shareholders, who concurs with the general views I have stressed.

The CHAIRMAN. Without objection, it may be entered.

(The information referred to follows:)

STATEMENT ON STOCK OPTIONS BY WILMA SOSS, PRESIDENT, FEDERATION OF WOMEN SHAREHOLDERS IN AMERICAN BUSINESS, INC.

Gentlemen, I hardly need remind you that there are more women stockholders than men. As most of you know, the Federation of Women Shareholders is a nonprofit voluntary association of women. Ever since 1940 when our charter was signed in New York State by Ferdinand Pecora, father of the SEC, we have been concerned with stockholders' rights and improving business ethics and the climate in Wall Street as well as taking means to help women and their families to preserve capital and income.

FOWSAB is the national organization of the women's corporate suffrage movement. We are unique. There is no other similar organization. FOWSAB has been frequently called the voice of the women.

No bill presently pending before Congress is more important than the six line bill introduced by Senator Gore to amend the Internal Revenue Code to terminate special tax treatment now accorded so-called restricted stock options. Here's why:

1. Options contribute to inflation and the wage spiral

Labor will continue to increase its demands, and rightly so, as long as special tax treatment is granted to corporation executives. Any woman knows that the fashions worn on 57th Street are soon copied on 14th Street but this is something our $100,000- to $600,000-a-year executives profess not to know when it comes to finance and wage negotiations. Stock options are contrary to corporate democracy.

2. Options create a tax elite corps

Proposals to withhold dividends and interest to plug up tax loopholes may be peanuts compared to the tax loophole provided by stock options which foster a tax elite.

3. Options cause a deterioration in executive morale

Stock options have caused executive morals to deteriorate with senior executives setting a bad example for junior executives. Many dump their old stock or optioned stock which they have bought with borrowed money in order to pay back loans or take up new options. Stock options tempt executives to overextend themselves. They tend to make executives more stock market-minded and less business-minded. Like price fixing, optioneering has become a way of corporate life. Senior executives who err themselves cannot discipline or keep in check junior executives.

For example: Shortly after testifying before the Senate on the need for stock options to give an executive a "proprietary interest" in companies, Benjamin Fairless, while chairman of United States Steel sold a large block of United States Steel stock (40 percent I think). He got very red in the face when I asked him at a United States Steel annual meeting about this, maintaining he was over 60 and needed the money. As I recall he indicated he was "in debt." He was furious when I suggested that he was setting a bad example for the younger generation.

4. Do stock options give incentive?

Yes, to gamble. Most top executives cannot or will not work harder than they are already working. Few of them choose to retire early.

5. Some executives wish they didn't have to grant stock options

Outside directors are sometimes like typhoid Mary, they carry bad as well as good habits from board to board. Stock optionitis has swept the corporate world but not all executives want them or believe in them. Lucius Clay, chairman of Continental Can, once told me he wished "we didn't have to give them." They cause problems for executives. The chosen few get stock options and some would rather not have them as they do not feel they can afford them. Others grumble because they do not get them and the employees that do not have some sort of stock purchase plan feel discriminated against.

6. When "insiders" sell their stock, it affects the price of the stock

Selling stock to pick up more options or to cash in on the market price affects the price of the stock. American Motors has never recovered in price from the time that its prexy, George Romney (now spoken of as possible candidate for Governor of Michigan) sold 10,000 shares. Stock options actually hurt stockholders, not help them when options lead to selling large blocks of stocks by executives, thereby underminding confidence in the company.

7. Two wrongs do not make a right

If there are inequities in the tax laws, there is no reason to try to compensate for them by creating another inequity.

Any probe of the stock market should include a probe of optioneering. I once sat at a broker's desk. He was talking to an executive. He urged him to sell short. His "client" was hesitating because he was selling optioned stock.

Stock options theoretically may look like a good idea but in practice drop by drop they poison the capitalistic system because of abuses. Management has indicated that it is not interested in stock options for proprietary reasons since it inevitably opposes resolutions which Lewis Gilbert, the Federation of Women Shareholders, and other public shareowners have brought in a large number of corporations including Standard Oil of New Jersey and United States Steel to prolong the holding period even by 1 more year or to eliminate other abuses.

The Federation of Women Shareholders in American Business urges the passage of the Gore bill to terminate special tax treatment for stock options, the corporate virus with which stockholders are currently afflicted.

The CHAIRMAN. Senator Carlson.

Senator CARLSON. I regret that it is going to be necessary for me to leave to attend the meeting of the Senate Foreign Relations Committee. We are marking up the foreign aid bill today.

I do want to state that this is an important hearing, it is a subject that I think needs much thought. Having served on the Ways and Means Committee for a good many years, and having served on this committee, I know it is not a matter which we should hurry through.

I have studied the matter somewhat. Henry Ford, of the Ford Motor Co., does not participate in stock options and I am not certain as to the policy of the company. I do not think it would be out of order to hear Mr. Ford on this important matter.

One of the consultants I have visited with was Mr. Joel Dean, New York, who made a study of stock options. I just suggest that we should not act too hastily.

Mr. GILBERT. May I correct the Senator; I am afraid Ford Motors does have these options.

Senator CARLSON. I was advised they do not.

Mr. GILBERT. They do.

In the current issue of the Harvard Review, Mr. Ford writes an article defending this viewpoint.

Senator GORE. In fact, they made a few millionaires in 1 day.

Mr. GILBERT. Yes.

The CHAIRMAN. Any further questions?

Senator KERR. You say:

I want to thank you for the opportunity to present the views of those shareholders.

To whom did you refer?

Mr. GILBERT. Thousands of individual shareholders each year correspond with me and of their own volition send me proxies for the various meetings where I happen to be a shareholder myself. And we issue this annual report, which is a nonprofit venture, once a year. And so I am speaking on behalf of all the letters and comments—and when we have our resolutions in the proxy statements—of those who think along these general lines.

Senator KERR. You have no identification other than your reference to them as "those thousands from whom you hear each year"?

Mr. GILBERT. That is correct.

These are public documents, and therefore on file with the Securities and Exchange Commission, which neither approves or disapproves it.

Senator KERR. You say: "Both as a shareholder in many corporations."

Mr. GILBERT. That is right, sir.

Senator KERR. Do you have the identification of those corporations?

Mr. GILBERT. Yes; indeed.

In our proxy material are examples typical of the holdings. I will be glad to make that part of the record if you so desire. We own stock in many companies, and they are not one share either, as some people occasionally get the impression.

Senator KERR. I am referring to your own identity as a shareholder.

Mr. GILBERT. Yes; this is my own identity. And we do not buy for the short term, we buy for the long term.

Senator KERR. When you say "we," to whom do you refer?

Mr. GILBERT. My brother, Mrs. Soss, the president of the Women Shareholders; Mr. Charles King, of New York; and Mr. Bill Blum,.

of Cleveland, Ohio, and so on, who think independently and are now representing the shareholders' views as we build a corporate democracy in the United States just as we have a political democracy.

Senator KERR. What do you refer to as a corporate democracy?

Mr. GILBERT. A corporate democracy is built on the use of the forum which was created by law, the annual meeting of the shareholders, to air their viewpoints. No one has to agree or disagree with them, but we have a right to air them, and we now record substantial votes each year, as is recorded in the chapter on stock options, of the people who think as we do, and the votes run into many hundreds of thousands. These are sent directly to the company, in support of our views, that, with regard to options, for example, there should be these kinds of holding periods, and so on. Of course, we would like to dispose of options completely as Senator Gore would like to do.

In other words, what we have been doing, and trying to do—you gave us a law, we have to abide by it—is to strengthen the viewpoints of the shareholders vis-a-vis the managers, because, Senator, the interests of the management and the shareholders are not always one and the same.

Senator KERR. You say the hundreds of thousands, you refer to shares?

Mr. GILBERT. I mean shares, sir.

Senator KERR. Not hundreds of thousands of stockholders?

Mr. GILBERT. No—well, in my annual report I will give in many cases the number of actual shareholders who have voted for these things, because many of the companies are quite cooperative in giving us that kind of information.

For example, here we have Sperry Rand, since you have asked it, taking that as an example, 14,000 shareholders representing 2,358,400 shares voted for our resolution that we should have these kinds of restrictions on options, such as holding periods, and so on.

Standard of New Jersey, 48,626 shareholders voted with us.

Senator KERR. Out of how many?

Mr. GILBERT. And the proxies against were 406,000, including the unmarked proxies and the proxies of fiduciaries, which are known not to vote independently, but always do whatever management wants. And that is covered very well in "Pension Funds and Economic Freedom," a publication of the Fund for the Republic, which describes the voting habits of fiduciaries, which is the reason, Senator Gore, that you could not possibly win in International Business Machines, in which I am not a shareholder.

Senator GORE. I did not expect to win.

Mr. GILBERT. Neither do I. But at least we have a right to try to end these things.

Senator GORE. I hope to end this issue in the Senate.

Mr. GILBERT. I certainly hope you do, on behalf of the small shareholders.

Senator KERR. I notice you say:

I have come today to plead the view that Senator Gore's initiative be enacted by the Congress.

Would you explain to the committee how that would be done?

Mr. GILBERT. By passing his bill, sir.

Senator KERR. In other words, then, when you wanted us to enact his initiative, you mean that you wanted us to enact his bill?

Mr. GILBERT. I stand corrected by the distinguished Senator from Oklahoma.

Senator KERR. I was not attempting to correct; I was just attempting to inform myself.

Then you did mean that you would like us to enact his bill and not his initiative?

Mr. GILBERT. Certainly.

Senator KERR. Well, I appreciate that, because I think so much of his initiative I would not want to do anything that would at all impair it.

That is all.

The CHAIRMAN. Any further questions?

Senator CURTIS. Mr. Gilbert, from the stockholder's point of view, would it be more desirable to have a corporation compensate its executive with the equivalent of take-home pay in the form of a salary?

Mr. GILBERT. Yes, I think so, I certainly do.

But the answer we are always receiving from these managements—and I am now talking purely objectively—is that with the present tax situation this is the only way we can get these incentives, and so on.

Senator CURTIS. Now, taxwise, how would the stockholder benefit by increasing the compensation of executives in lieu of the stock option?

Mr. GILBERT. You have raised a very important point, Senator.

The stockholders get no tax deductions as a corporation—we are talking about the corporation. Every proxy statement will show there is no deduction when we grant these stock options; that is clearly spelled out in proxy material.

Senator CURTIS. No; but what about whatever they pay out in compensation?

Mr. GILBERT. That is tax deductible.

Senator CURTIS. And it lessens the amount of money available to distribute to shareholders; does it not?

Mr. GILBERT. No. In spite of some abuses, the overall executive compensation as such would not run into such material amounts on a per share basis.

Senator CURTIS. I am not talking about the amount. But any money that is paid in compensation, whether it is for executive or employees, that much less money is available to distribute to the owners; is it not?

Mr. GILBERT. The dilution of equity makes that much less to be distributed to the owners afterwards, because you have got that much more stock you have got to pay dividends on.

Senator CURTIS. Now, how have stockholders generally fared in terms of market value of their stocks during the period when stock options have been operative in a large number of companies since 1950?

Mr. GILBERT. May I again repeat the authoritative viewpoint, because it is the best one I have seen yet.

Emmett Wallace, an associate of the firm of James O. Rice Associates, wrote in the Harvard Business Review—he had made a year's study of the incentive effect of restricted stock options, and had

found after looking at 38 cases of option and nonoption corporations that there was no statistically significant difference in share price appreciation between the paired firms. He wrote:

> While 14 option companies showed performance significantly superior to their mates, 5 did no better, and 19 performed significantly worse.

Senator CURTIS. Do you have the companies listed there that he refers to?

Mr. GILBERT. Emmett Wallace, associate of the firm of James O. Rice.

Senator CURTIS. No; what companies did he review?

Mr. GILBERT. This I do not know. I have not corresponded with him.

Senator CURTIS. Have you made any such study?

Mr. GILBERT. I have not made any particular study, except, as you have heard me say, the New York, New Haven & Hartford did not do any better with options, in fact they have gone bankrupt.

Senator CURTIS. I am not suggesting that in stock options, as any other field, there are not things which demand the attention of Congress, they always do. But do you think stock options are a material factor in determining the survival of a railroad in the light of the many complications in the field of transportation and cost of right-of-way and local taxes on right-of-way running into cities, and the many problems a railroad faces?

It is not a significant matter; is it?

Mr. GILBERT. I cannot agree with it.

At least, this is the argument that is printed in proxy material of railroads and everyone else, and these managements say: "This is what we need, we have to have these stock options to compete with other people, and get the best talent." They make these claims.

Senator CURTIS. But do you make the claim that a railroad or a number of railroads got into serious trouble, and the fact that they had a stock option program was a significant contributing factor?

Mr. GILBERT. I have quoted Mr. Leslie Gould as saying very definitely—and his wife was with Capital Airlines, and he knows what he is talking about—Capital Airlines got into trouble, he stated, exactly for this reason, because a lawyer who was on the board, and the dominant shareholder there were far more interested in nonequity financing rather than—for the reasons I mentioned before. And he states very distinctly that this is one of the reasons that Capital Airlines got into trouble, and might not have otherwise.

Senator CURTIS. My question had nothing to do with airlines.

Mr. GILBERT. You said transportation——

Senator CURTIS. No; I referred to the problems in transportation, and I asked about railroads.

Mr. GILBERT. Yes. Mr. McGinnis is another exponent of all this, up at the Boston & Maine.

Senator CURTIS. Well, is it your contention that the existence of a stock option program in a railroad company is a significant factor in whatever financial problems any railroad or all the railroads might be facing at this time?

Mr. GILBERT. In my opinion, it certainly is, because it encourages speculation.

Senator CURTIS. And as compared with all the other problems in the field, you would say this is still significant?

Mr. GILBERT. I certainly do.

Senator CURTIS. What evidence do you have that stockholders would have fared better during the last decade if corporation officials had not had the incentive provided by stock options?

Mr. GILBERT. There would have been that much less stock outstanding in many corporations.

We cited the American Motors situation as an example.

Now, obviously when Romney had to sell that stock—and I am not a stockholder in that company, so we are talking completely objectively—when he had to sell at $90, the stock dropped gradually to $60 as soon as the news came out that he was selling the stock he had obtained from options.

He gave the reasons, which I cited in my testimony. This did not prevent, obviously, the decline, the strong decline.

And then there is another great danger to the shareholders. You know there is this reduction question. In many of these option plans you can reduce the option price. So if the stock goes down, actually they could—I do not say that any reputable company wants to do it, but there is that temptation that does exist—they could say, "My stock has been 60, if I don't do so well I will change the option price, and if the stock goes down to 30, I can buy my stock that much cheaper."

These are all possibilities.

Senator CURTIS. Your position is that the whole thing should be repealed rather than any changes which might deal with some abuses or cases of mismanagement, cases that might be well established by competent evidence.

Mr. GILBERT. I much prefer to see Senator Gore's bill ending the thing, because then managements cannot all come and say we have to have options.

Mrs. Soss in her document said that General Clay said:

> I wish we did not have to do it, but we have to do it because everybody else is doing it.

In the Atlantic Economic Review, where I have just written an article, I have said let's at least have holding periods. Now that was before the Senator brought this whole matter into the open and showed that there was some sentiment at least in Congress for the ending of this special tax benefit.

So between the two, of course I would prefer not to have any options. But if we have to have them, then at least let's have some of these restrictions which we do not now have.

Senator CURTIS. But you are advocating doing away with it?

Mr. GILBERT. I certainly would much prefer it.

Senator CURTIS. Now, is not a stock option somewhat similiar to an option to buy stock which anyone can obtain from a put and call broker?

If so, why should it be taxed differently?

Mr. GILBERT. Put and calls are a form of speculation which I know nothing about. I own my stock outright, I do not buy puts and calls, I am not interested in puts and calls; I am interested in the shareholders who want to stay with a company, not those who want to get out of a company.

Senator CURTIS. I think you pointed out something very significant here, that often times management and ownership are two distinct entities.

Do you think that is a good thing?

Mr. GILBERT. No, I think this is why it is so important that, we have the forum of the annual meeting, and that we do encourage proprietary ownership. But then that really means proprietary ownership.

The Cheeseborough Pond case is an example of where you have a distinct employee stock purchase plan, where they have to guarantee that they are going to keep the stock for 5 years, and——

Senator CURTIS. But you are not advocating such a change in the law; you are advocating doing away with this?

Mr. GILBERT. I advocate doing away with options. They are an entirely different thing from a bona fide stock purchase plan where you have got to put the money down and sign a real commitment. That at least has some sense. But this option theory to me is becoming increasingly abused. These abuses were the things that everybody feared at the beginning, and unfortunately they are increasingly coming to pass. And they are going to become more and more troublesome unless we do something about the whole option situation.

Senator CURTIS. I cannot reconcile the inconsistencies in your position, that management and ownership are often different entities, and that this is bad. Instead of wanting to correct abuses in a plan set out to encourage ownership on the part of management, you suggest that it be done away with.

Mr. GILBERT. Because options are not doing what you had hoped they were going to do, Senator; that is exactly the trouble.

In other words, when Mr. Deagan sells every share of stock which he has got except 11 shares, as soon as he can do it, are we encouraging stock ownership?

Of course we are not.

Senator CURTIS. Of course, you can take any provision of the Internal Revenue Code and cite some poor examples which point up to the problem that there ought to be some corrections. It is not easy to write a tax law to gather revenue and at the same time promote economic growth in a country where we have 180 million people, a complicated society, a complex industrial setup, and 50 sovereign States who write laws as to property rights—all of which I am not complaining about, I think it is a blessing—but it is not easy to write the simplest part of the Internal Revenue Code without coming up afterward with a few examples and some things nobody intended.

But as I understand your positon, it is that you favor ownership on the part of management.

Mr. GILBERT. I do.

Senator CURTIS. But you are for repeal of a provisioon that gives an incentive to do that, has brought it about in many instances, because there are some abuses.

Mr. GILBERT. At very high cost in any of the cases where it has been achieved.

In other words, those receiving options have had to sell so much of the stock. The *Fairchild Camera* case, which is a different one from the *Fairchild Engine*, which is also described in this magazine which

I would be delighted to leave with this committee, shows how expensive this thing can become.

Senator CURTIS. Expensive to whom?

Mr. GILBERT. To the shareholders.

Mr. Carter went out and exercised his option at $9 a share. The stock is selling at $150 a share. He had to give up 4,000 of his shares. He still has 9,250 shares. And on the floor of this meeting I said--

Well, as you know—

while I had nothing to do with the case, because I did not get into that kind of litigation, I don't go into it—

you know I have very little sympathy for options, which is my right just as yours, and the others. So I cannot weep for you on the option question.

Mr. CARTER. You will also understand why I will make no comment on that. [Laughter.]

Mr. GILBERT. I certainly do. And personally, I hope that Senator Gore's bill will go through, it will stop this, so everybody will not have options.

Mr. CARTER. Believe me, I wish you every misfortune in that endeavor.

Senator CURTIS. You do not speak for all shareholders?

Mr. GILBERT. I have described the shareholders for whom I speak, in reply to the Senator from Oklahoma.

Senator CURTIS. How many shareholders are there in the country?

Mr. GILBERT. There are now supposed to be 12 or 15 million. But this takes in a great many mutual funds and things like that.

There is a question as to what the real figures are; I do not think we have come to a real analysis of it.

Senator CURTIS. But there are some 12 million?

Mr. GILBERT. Yes, I think we can probably get along and say that there are. And as I say today, I do not think there is any question that there are hundreds and hundreds of thousands of shareholders who are now seriously concerned with this whole option question.

And if I might, I should like to quote what the distinguished junior Senator from Virginia said on this very subject a few years ago at a hearing of a subcommittee of the Committee on Banking and Currency, on February 12, 1957:

I have been astounded sometimes at what the officers of a corporation can get as a bonus in the way of a stock option. They get stock, and unless it goes up they do not buy it. If they do buy it and do not want to hold it, they can sell it after 6 months and take a capital gain, and it is a tremendous income for them.

Senator CURTIS. Now, one more question: Short of repeal of this, what would you suggest as legislation which would remedy the evils you see?

Mr. GILBERT. Yes, sir. I am very glad to make some comments on that.

First of all, I believe that we should have the repeal, and then establish, in a new bill, options with some proper safeguards for the share holders, such as, stock must be held for a certain time after exercise—remember, before exercise means absolutely nothing, because, as Dean Griswold has stated, that is a "heads I win and tails you lose" proposition. But, after exercise, stock should be held at least 2, 3, 4, 5 years.

Now I have influenced a number of corporations, because they recognize that many think as we do on this subject, such as Fairbanks Whitney, George W. Helm, P. Lorillard, 20th Century-Fox to put in holding periods of 2 or 3 years after the options are exercised.

Now this is a step in the right direction, once we rewrite a new bill, after we end this general abuse, as I see it.

Second, I agree with the viewpoint of the former Chairman of the Securities and Exchange Commission, who has retired, Mr. Gadsby, in the case of *Middle South Utilities*, where he put restrictions in the plan. As you know, in public utilities holding companies the SEC has more than the right to require full disclosure. It has to decide whether things are fair and equitable. In this case, the SEC insisted on 100 percent of the market, which I have agreed on, at least—it is bad enough to have the option without giving him added inducement—and it would certainly be at the fair market value on the day it was exercised also.

Senator CURTIS. What kind of an option would that be?

Mr. GILBERT. More and more of them are now doing it that way, sir. That is getting quite general. But there are still some of them which insist on the 85 and 95 percent clause—in other words, if the stock is selling at 10, that is the price they would have to pay.

Also, the Securities and Exchange Commission insisted, and rightly, that options should have some relationship to a man's earning power. So you do not have this wild speculation, and you do not have to go and dump all this stock on the market. In other words, what they said was, the option could not be for more than 150 percent of the recipient's earning power.

The CHAIRMAN. What do you mean by earning power?

Mr. GILBERT. Salary for that year, the aggregate.

Also, a very definite percentage had to be reserved for the junior executives. And let's go right down the line further than just the top brackets if we are going to really have increased proprietary ownership in this country.

Then I am all for a noncumulative feature. In other words, by noncumulative—this is the only time I am not for cumulative voting, it has got nothing to do with that—I mean that if the option lasts for 10 years the optionee can only exercise a certain amount each year. Most plans do have this much, but in addition, which most of them do not have, if he has not exercised the option in a given year, he must then lost that part of it, because otherwise what happens is that 10 years may pass, and all of a sudden something which has no connection with his business ability whatever—he has never exercised a share, but something unexpected has happened, and has created a sudden demand. For example, years ago when salt was dying, suddenly chemicals came in and everybody needed salt, and International Salt went 'way up. A situation like that might happen, and then the stock suddenly soars, not because of what he has done, but because of somethink that happens elsewhere. And then he takes the entire block. That should also be stopped.

Senator CURTIS. Why do you say that repeal must come first?

Mr. GILBERT. Because otherwise the abuses are going to outweigh the advantages. This is the way I look at it.

Senator CURTIS. I do not understand you.

If Congress has a right to repeal something without upsetting contractual arrangements existing, why would it not have the same right to reach just as many contracts by changes in existing law?

Mr. GILBERT. In the first place, if I might say it, you are getting into the session late, sir, and all this takes a great deal of time. So it would appear to me that it would be far more advantageous to end the stock option at the present time as far as capital gains profits are concerned.

And then you heard the Treasury expert here today say it would take a certain number of months, and Senator Gore pointed out that he would like it as soon as possible.

Senator CURTIS. I read the statement of the Treasury.

Mr. GILBERT. Well, it was an interpolated statement.

Senator CURTIS. Did the Treasury counsel recommend repeal at this time?

Mr. GILBERT. I would prefer to have the Senator give the answer, because the Senator's questions—my recollection is that he said he wanted to have more time for it.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. Senator Gore.

Senator GORE. You believe that the abuses in the practice of widespread distribution of restricted stock options dilutes the value of the stock in our corporate structure?

Mr. GILBERT. It certainly does, because the more stock that is outstanding, the harder it is to earn those dividends.

Senator GORE. Now, if the stock of a corporation has a market value of $20, and 1 million shares are sold, that would represent equity capital to the corporation of $20 million; is that correct?

Mr. GILBERT. I believe it is.

Senator GORE. Now if, instead, those 1 million shares are sold under a restricted stock option plan to a selected few insiders at $10 a share, does not that corporation suffer a loss of $10 million.

Mr. GILBERT. I think you are right.

Senator GORE. And to distinguish between that loss, which, in answer to Senator Curtis, you described as nondeductible, and compensation, the latter is deductible as a business expense and the former is not?

Mr. GILBERT. That is right. That is exactly the point I was trying to make.

Senator GORE. As I understand Senator Curtis, he was trying to group the two together. But they are two different animals.

Mr. GILBERT. Entirely different.

We get the proxy statements that tell us distinctly that we as a corporation get no benefit from stock options. So you do not get the benefit that you do from compensation.

Senator GORE. You say you receive letters and proxies from thousands of stockholders. I have received no proxies, but, as a result of my initiative in this fight, I have received many letters and telegrams, including copies of statements and stock option plans of corporations.

As a result of one such exchange, I corresponded with a Mr. John B. Fowler, Jr., chairman of the board of Seaman Bros. This letter from Mr. Fowler shows that in many instances the shares reserved for restricted stock options amount to as much as 10 percent and more of the shares outstanding.

Mr. GILBERT. It will grow worse, Senator, unless we do something about it. That is why I pointed out that the median had risen already from 4 to 7 percent. And they come for round after round.

Senator GORE. Well, is this not, then, a moral question?

Mr. GILBERT. I have certainly thought that it certainly is a moral question, and I have so stated many times when I have spoken, not only on the floor of meetings, but lecturing, and so on.

Senator GORE. When the insiders of a corporation deliberately water and dilute the stock of the stockholders, I believe a moral question is involved. And if public opinion grows to the effect that the executives of the corporations of the country are unfarily dealing with the stockholders, and by terms of the law avoiding taxation on income, then this brings contempt on the part of millions of taxpayers for the tax policy and law of our Government.

Mr. GILBERT. I must agree with you.

Senator GORE. Mr. Chairman, I ask unanimous consent to have printed at this point in the record this exchange of correspondence with Mr. Fowler.

The CHAIRMAN. Without objection, it will be so printed.

(The information referred to follows:)

MAY 26, 1961.

Mr. JOHN B. FOWLER, Jr.,
Chairman of the Board, Seeman Bros., Inc.,
New York, N.Y.

DEAR MR. FOWLER: Upon examining the proxy statement sent to stockholders of your company in preparation for the June 14 annual meeting of stockholders, I note that it is proposed to increase the number of shares of common stock subject to your restricted stock options plan to 125,000. I also note that there are 695,015 shares of common stock outstanding.

It seems unusual that 18 percent of the outstanding shares of common stock of a corporation should be reserved for restricted stock options. It may be that I have misinterpreted the information in the proxy statement which appears to so indicate. I would appreciate it if you would clarify the matter for me and would be glad to have your comments.

Sincerely yours,

ALBERT GORE.

SEEMAN BROS., INC.,
New York, N.Y., June 20, 1961.

Re employees' restricted stock option plan.

Hon. ALBERT GORE,
U.S. Senate, Committee on Foreign Relations, Washington, D.C.

DEAR SENATOR GORE: Thank you very much for your letter of May 26, 1961, indicating your view that the reservation for employee stock options of shares of common stock of Seeman Bros., Inc., aggregating 18 percent of the outstanding shares of such class of stock seemed unusual.

In arriving at the 18-percent figure, I note you use the figure of 125,000 shares of common stock which is a total amount reserved for all stock options already granted or which may be granted in the future. I respectfully submit that a more relevant figure would be obtained by taking the number of shares for which options actually have been granted at the present time which, as described on page 6 of the proxy statement for the June 14, 1961, annual meeting of stockholders, is only 88,944 shares. The 88,944 figure would seem to be more relevant than the 125,000 figure because the stock option committee of Seeman at the present time does not intend to grant additional options. The shares in excess of present requirements for options granted are reserved in order to provide for the acquisition of additional executive personnel which may result from future expansion by the corporation. Any such future expansion by Seeman could reasonably be expected to involve the issuance of additional shares for assets in which case the grant of additional options might not increase the ratio of shares subject to options to total outstanding shares.

In arriving at the 18-percent figure you apparently considered only the 695,015 shares of common stock which were outstanding on April 17, 1961. This figure is also perhaps not relevant because of the number of reserved shares of common stock. You will note from page 1 of the proxy statement that the corporation had outstanding on April 17, 1961, 225,630 shares of 5-percent cumulative convertible preferred stock. Such stock is convertible into common stock of the corporation on the basis of approximately 1.02 shares of common stock for each share of preferred. Therefore, as of such date approximately 230,000 shares of common stock were reserved for issuance upon conversion of such preferred stock. Since shares of preferred are being regularly converted in large numbers into shares of common stock at the present time, it is anticipated that all of the common stock reserved for issuance upon conversion eventually will be issued. In addition, in connection with borrowing by the corporation, a warrant was granted on February 23, 1961, to the lending insurance company to purchase approximately 25,000 shares of common stock. Accordingly, 25,000 shares of common stock have been reserved for issuance upon the exercise of the warrant. In all likelihood, the warrant will be exercised since the common stock is presently quoted on the American Stock Exchange at a price greatly in excess of the exercise price of the warrant.

Including the 230,000 shares of common stock reserved for issuance upon the conversion of the preferred stock, the approximately 25,000 shares reserved for issuance upon the exercise of the warrant and the 125,000 shares reserved for stock options, I believe that the total amount of shares of common stock subject to stock options already granted is only approximately 8 percent of the total number of outstanding and reserved shares of common stock of the corporation. Even comparing the entire 125,000 shares of common stock reserved for options to the total outstanding and the reserved shares of such stock, the percentage is only 11.6 percent.

Such percentages are not at all unusual. I wish to refer you to a study published in 1956 by the New York Stock Exchange entitled "Stock Ownership Plans for Employees." The study demonstrates that it is not unusual for corporations to grant options on shares aggregating more than 8 percent or even 11.6 percent of outstanding shares. Both large and small corporations have commonly approved such plans. The following information was drawn from such study.

Percentage of shares subject to stock options to outstanding shares

Name of corporation:	
Arnold Constable Corp	11.86
Columbia Broadcasting System, Inc	15.65
Electric Boat Co	14.38
Aluminum Co. of America	10.00
Bohn Aluminum and Brass Corp	11.35

Although the above percentages were based upon oustanding stock, without including stock reserved for issuance, the statistics are useful for comparison since it is likely that all of this corporation's reserved common stock will be issued.

I believe that the value of stock opinions as a means of providing management incentive has been clearly demonstrated in the case of Seeman Bros., Inc. During 1959 there were a number of changes in the personnel of Seeman and at that time stock options were granted to the officers and a number of key employees. The corporation's earnings increased from 46 cents per share for the 52 weeks ended June 27, 1959, to $2.52 per share for the 52 weeks ended February 25, 1961. I would also like to point out that more than 60 employees hold options for shares of Seeman stock.

I shall be happy to answer any further questions with respect to Seeman's employees' restricted stock option plan.

Faithfully yours,

JOHN B. FOWLER, JR.,
Chairman of the Board.

Mr. GILBERT. And could I put in the record those documents which I talked about and which came up during the discussion, such as that Fairchild Camera postmeeting report which deals with that subject?

The CHAIRMAN. You may submit them to the Chair, and he will look them over.

(The material referred to was made a part of the committee files.)

The CHAIRMAN. The Chair offers, too, for the record a reprint of an article by Mr. Henry Ford II which appeared in the July–August 1961 issue of Harvard Business Review. The article is entitled "Stock Options Are in the Public Interest."

(The article referred to follows:)

[From the Harvard Business Review, July–August 1961]

STOCK OPTIONS ARE IN THE PUBLIC INTEREST—SAYS THIS COMPANY PRESIDENT; THEY PROVIDE A VIGOROUS INCENTIVE FOR ONE OF OUR MOST IMPORTANT NATIONAL RESOURCES, MANAGEMENT

(By Henry Ford II)

(EDITOR'S NOTE.—When Mr. Ford wrote this article he was president of the Ford Motor Co.; just recently he relinquished the presidency, and is now chairman of the board of that company.)

Economic incentive is a subject of continuing controversy spanning a broad range of political and economic viewpoints. Recently, a relatively new form of economic incentive, the restricted stock option, has been singled out for critical attention. Some of this criticism is constructive and is aimed at improvement of the law governing stock options. Some of it seems directed at destroying the restricted stock option provisions of the law.

I have a particular interest in restricted stock options because, as the chief executive officer of Ford Motor Co., I am explicitly accountable to nearly a quarter of a million stockholders for the good or bad management of the company, the success or failure of the business. And I feel qualified to speak more or less dispassionately on this subject because, although I am familiar with the uses and effects of stock options, I do not and will not hold any options on stock of our company.

I am convinced that the restricted stock option is a powerful incentive to good management and an important contributor to economic progress—and that it can be made to serve still better the broad goals of our society.

NEED FOR REALISM

I am aware, of course, that there have been imperfections in the administration of certain stock option programs and that, in a few cases, the good and constructive intent of stock options may have been thwarted. This is not at all surprising in view of the brief history of this form of incentive and its admitted complexities. If management still has much to learn about stock options, however, it already has learned a great deal about the efficient, productive use of this device and has, by and large, corrected many of the shortcomings to which critics of the stock option have pointed in alarm.

The real question is, How are stock options working today?

Both the law and the administration of options undoubtedly can be improved. Careful consideration should be given to further study to determine whether specific provisions of the law should be modified. As for administration, if stock options amount only to unearned and quickly realized bonanzas rather than to continuous inducement to better performance and if the optionee gains no real and lasting sense of proprietorship in the business, management is guilty of misusing one of the most effective tools at its disposal.

But certain other common criticisms of restricted stock options appear to me to be the result of too little objective information and, for that reason, are greatly exaggerated. I want to deal with these in some detail later in this article. First, however, I should like to state why I believe that stock options produce good and useful results, and why we should attempt to improve, rather than limit, the effectiveness of this important economic incentive.

The Ford story

During the early postwar years at Ford Motor Co., a dozen or so skillful men—executives brought in from outside after the war—transformed a bogged-down, antiquated, money-losing company into a modern, efficient, profit-making enter-

prise, capable of meeting the toughest kind of competition, of improving its position, and of renewing its own management resources. Largely through the efforts of these men, the company became a substantial net contributor to the managerial and technical capabilities of the economy. Furthermore, by stimulating more intense competition in the automobile industry, the company added to the general prosperity and growth of the 1950's.

Without the guidance of these men, the stockholders' equity might be half of what it is today. The contribution of this group to the growth and profits of the company has far exceeded any financial rewards they received in return. Many of these executives were already established, successful, and well paid. We could not have offered them enough more in salary and possible bonuses to justify the risk of leaving secure positions for the uncertainties of our situation. They joined Ford Motor Co. largely upon my promise that I would do my best to give them an opportunity to acquire a stake in the company as soon as it was feasible to do so.

At the same time, we also developed a group of exceptionally able younger men who contributed materially to the company's growth and who were not being rewarded commensurately with their contribution. These young men—including a number of the leading executives of the company today—saw opportunities for realizing large capital gains outside the company. Some outstandingly capable people left us for that reason. Indeed, at one time, before we could offer stock options, we had a serious problem with sales executives leaving us to go into business for themselves as dealers.

When the Congress authorized restricted stock options by amending the Internal Revenue Code, it gave us an effective means to recognize and stimulate exceptional performance, and to protect the company's future by conserving its management "seed corn." In 1953, when our only shareholders were members of the Ford family and the Ford Foundation, the board of directors made its first grants of restricted stock options to 114 key employees, thus breaking a tradition of long standing. Stock options have since been offered from time to time to key employees.

We have had no reason to regret that decision. I am convinced that, in broad effect, stock options have helped materially to raise the company to third place among American industrial corporations in total dollar sales. Without stock options or some comparable incentives, the same results would not have been achieved.

A NATIONAL RESOURCE

The use of stock options to attract and hold managerial talent is not without public interest.

Companies, big or little, don't just roll along. Certainly, the quality of top management among corporations is the main differentiating factor. Management, good or bad, determines whether any one company grows or declines, succeeds or fails over the long pull. Even in a large company, the influence on profits of one or two men is likely to be very great, and the general ability and dedication of the top 100 men can make or break any company. That is why knowledgeable investors assess the caliber of a company's management before they buy its stock.

And if able management is critical to the individual company, in the aggregate it is equally critical to the whole economy. Good management of private business insures maximum growth in the economy, while poor management impedes that growth, wastes capital and labor, leads to stagnation. Thus, because the productivity of capital and labor is so closely tied to the quality of management, everybody's income and standard of living—as well as our national security—depend heavily on how well managers do their jobs.

But management talent is a scarce and very precious national resource. To make the most efficient use of this national resource, we must find ways to put and keep our best business managers in the most important jobs—jobs that make the broadest use of their talents and have the greatest impact on the society's total economic performance.

Once we have managers in these important jobs, the next essential step is to provide incentives for them to work most effectively and productively.

Monetary incentives

Yet some people deplore the emphasis our economic system places on the monetary incentive, both for individuals and for business enterprises; the desire for gain, for material recognition, is linked with the sins of greed and gluttony.

I know that monetary incentive is important in getting men to produce the results that a corporation must have if it is to survive and prosper. It follows that monetary incentive can and does serve society well. I reject out of hand the notion that such incentive is unworthy or reprehensible.

While I certainly agree that there are many kinds of incentive, and many kinds of men, and that more money does not necessarily make a hard-working man work harder. I completely disagree with the idea that monetary gain is an unimportant incentive. For executives in the business world, it would seem axiomatic that the money incentive is primary, just as the drive for profit is a prime incentive of individual business firms and, indeed, of the whole economy.

So long as such drives may be harnessed to good ends, I can see no reason to be disturbed or ashamed that the acquisitive instinct is strong in men, that most of us do have aggressive drives and ambitions. It is the very genius of our economic system that it channels these powerful, potentially destructive, personal drives into the highly organized, cooperative management systems that have contributed so much to our Nation's well-being.

Our system works well because it persuades managers that they are working for themselves when they are, in reality, serving the total economy. Actually, they are unable, as a rule, to keep more than a token of the wealth that their efforts create.

I often wonder whether the really important distinction between private enterprise and socialism is not the superior motivation that our system offers. We sometimes forget that one of the great advantages of our economic system is that in it capital may be privately owned. Our system uses capital not merely for investment but also as a potent incentive to risk, invent, and persevere. If the Communists could find a way to match the incentive that is in the drive of individuals to acquire capital, they might be hard to beat.

Ideally, our whole economic system should be geared to provide maximum opportunity to each generation. We should seek ways to increase manifold—rather than decrease—the number of people who can hope to achieve substantial wealth. Is there any better way to do this than by enhancing their opportunity to contribute to the economy? It seems not only just but productive that the people who contribute substantially to the economy should own at least a part of the capital.

Soviet imitation

Today, a very live subject in Soviet economic journals is the improvement of personal incentive throughout Soviet industry. Here are some statements from recent articles by Russian management experts:

"The present system of bonus payments * * * provides little stimulus to managerial and engineering and technical personnel. * * *"[1]

"Managerial and engineering and technical personnel are, to a substantial degree, responsible for success * * * a substantial portion (let us say 15, 20, or 30 percent) of the total bonus fund should be set aside for this category."[2]

"One of the conditions for raising the economic level of the enterprise' work is the establishment of economic stimuli and insuring the interest of the leadership and the collective body of the enterprise. * * * One of the measures designed to increase this interest could be the establishment of a procedure under which a larger part (of profits) would be included in the enterprise (or bonus) fund."[3]

The very time at which our country's foremost competitors are improving the effectiveness of their monetary incentives—incentives that are not, as ours are, greatly weakened by progressive income taxation—is obviously not the time to be weakening our own.

By all sound means we should endeavor to increase the rate of our economic growth to the end that we may be more effective in meeting the economic and political challenges of those who seek to dominate the world. The way to do that is to take out of our system the things that slow it down (featherbedding, resistance to technological change, and the like), and put in more of the things

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[1] E. Manevich, "The Principle of the Personal Incentive and Certain Wage Problems in the U.S.S.R.," Problems of Economics: Selected Articles From Soviet Economic Journals in English Translation, January 1959, pp. 20–26.

[2] A. Zaytsev and F. Dronov, "Problems of Material Incentives in Government-Owned Enterprises," Problems of Economics: Selected Articles From Soviet Economic Journals in English Translation, March 1959, pp. 35–40.

[3] E. Khalfina, "The State Enterprise Under the New Conditions of Industrial Management," Problems of Economics: Selected Articles From Soviet Economic Journals in English Translation, May 1959, pp. 39–43.

that encourage inventors to invent, artists to create, entrepreneurs to risk, and managers to manage wisely and well.

In a free enterprise economy, good management is profit-conscious management. And don't forget that society depends on this kind of management to generate the national production to support nonprofit institutions such as hospitals, schools, research organizations, and government, and social benefits such as unemployment compensation and social security.

DOUBLE-BARRELED EFFECT

It was the clear and deliberate intent of the restricted stock option legislation to strengthen incentives to good management. In 1950, when the 81st Congress passed, and President Truman signed into law, a provision authorizing restricted stock options, they were not acting on hasty impulse.

The basic proposals for this kind of reform had been recommended to the Congress 3 years earlier by major professional organizations and by the special tax study committee appointed in 1947 by the Ways and Means Committee of the House of Representatives. This study committee, incidentally, was headed by Roswell Magill, a former Under Secretary of the Treasury (1937-38) and one of the most widely respected authorities on tax law.

These proposals were extensively reviewed in committee hearings, approved by the Ways and Means Committee, and passed by the House before the adjournment of the 80th Congress. The bill incorporating the substance of these proposals and much of their language, which was reintroduced in the 81st Congress, carried the specific recommendation of the American Bar Association.

Hearings and reports on these bills stressed again and again the importance of stock options as incentives. Our experience at Ford—and what we have learned from the top managements of other corporations—confirms the fact that the stock option is effective for two main reasons:

1. It represents an opportunity for gain that is especially sought after, but that will be realized only if the stockholders benefit.

2. It establishes a proprietary interest which aligns the executive's personal interests closely with those of stockholders and thus, from their standpoint, affects favorably his day-to-day business actions and decisions. Specifically, it strengthens his interest in the long-term growth and health of the organization.

Now let me point out some important implications of these two points.

Inducement for managers

The stock option has a powerful attraction because it offers to the corporate executive his most promising means of building a nest egg. The desire to do so is deep and widespread, reflecting universal human urges for economic security and independence.

At present levels of progressive taxation, it is almost impossible for a top-salaried executive to create a substantial estate out of income. To do so requires that he devote to minimizing taxes and seeking outside capital gains much time and energy that, in the stockholder's view, certainly ought not to be diverted from his job.

Now the desire of the executive to build an estate may be viewed in different ways: (1) as an unworthy, mercenary, greedy sort of thing, or (2) as a way to move people to do constructive things. It is hard to understand what leads some of us to take so grim and puritanical a view of people being normally acquisitive and wanting tangible things (like cars and houses and TV sets) and intangible things (like financial security and independence). Certainly our whole economic system is based on people wanting more and more, and, beyond that, on their being able ultimately to get many of the things they want, granted that these are not the be-all and end-all of life.

The urge to acquire is natural. It exists. And it is very much in the interest of society to see that this urge is used constructively.

Gain for stockholders

From the stockholder's standpoint, the stock option has proved to be an excellent means to take advantage of this urge. It is an opportunity for capital gain that links the fortunes of top executives most directly with those of the stockholders.

As I have suggested, the stock option is far more than a means of getting and keeping the most capable men in, economically, the most critical jobs. Its pe-

cular effectiveness lies in bringing about a fundamental change in executive attitude. It leads the executive to think and act less as a hired manager or trustee, and more as an owner-manager. I have seen this happen in a hundred and one ways since we instituted a stock option plan at Ford Motor Co. The change in attitude that comes with a proprietary interest—or even with the prospect of eventually earning such an interest—is almost always evident, though it is seldom precisely measurable.

Stock options work.—They work in exactly the way that they are supposed to work. Only those without experience in management, I believe, would argue that management can be made to work as effectively without such incentive.

As far as I am concerned as a stockholder, the goal of Ford Motor Co. is explicit: it is the long-run improvement of profits consistent with the best interest of our stockholders, our employees, our dealers, our suppliers, and the public at large. So long as the executive considers himself a mere hired hand—no matter how able, conscientious, and well-paid a hired hand he may be—his interests, his viewpoint, and his goals may conflict with this basic stockholder objective that should be the guiding objective of all management.

I have mentioned the distractions arising if an executive seeks to create on the outside the nest egg that his job is not providing. There are numerous other temptations for the executive who is only a hired man:

Staff professionalism—the good and necessary desire of staff offices to provide the most excellent professional services—may lead to costly overstaffing.

Paternalism may creep in, leading to inefficient and wasteful practices.

An executive's decisions may be guided by an excessive regard for corporate and, by extension, his own security.

The pursuit of pet projects may be placed ahead of the overriding interests of the business.

Profits and profit growth may be subordinated to spectacular sales results and excessive investment in facilities (empire building).

Certainly there are forms of incentive other than stock options. An awareness of the relationship of employee interest to the company's success may be encouraged by profit-sharing plans, stock purchase plans, and the like. But such plans are a less compelling stimulus than the stock option in focusing attention on the longrun interests of the corporation, as distinguished from short-term results. Furthermore, building a profit-oriented attitude by small, periodic doses is a slow process. In some instances it is desirable to create an immediate stake of appreciable size—a purpose the restricted stock option is admirably suited to serve.

CHARGES OF CRITICS

Let me turn now to those criticisms which, if not always sophisticated or nonpartisan in nature, nevertheless deserve thoughtful examination.

Cost to the public

It is argued that options are unduly costly to the public at large through loss of tax revenues and to stockholders through dilution of their equity.

The argument that a restricted stock option plan is paid by Federal tax subsidy has little, if any, substance. For each dollar of incentive provided in this way, as against a dollar of salary or other compensation, the company is required to give up a tax deduction worth 52 cents. If the optionee sells his stock, he must pay an additional 25 cents in capital-gains tax. In total, then, the Treasury stands to receive 77 cents for each incentive dollar.

This is a high rate of tax return for the Treasury, considering that the top individual tax bracket is 91 percent. True, there may be exceptions in unusual cases, and the optionee can always escape his part of the income tax, although not the estate tax, by holding on to his stock until he dies. But it does not appear that Federal revenues are suffering appreciably on this account or that repeal of these provisions would bring about any significant increase in tax revenues. Furthermore, insofar as stock options generate higher corporate profits for the economy as a whole, they add to the tax base and to Federal revenues.

Cost to stockholders

As for the claim that options are unduly costly to stockholders through dilution of their equity, I know no way of measuring dilution precisely. Certainly I cannot determine exactly the dollars-and-cents cost to our company of the options we have granted, any more than I can count the dollars-and-cents contri-

bution that options have made to the company. Yet I am convinced that the total cost to stockholders has been very small compared to the direct benefit obtained.

The point is, of course, that options cost nothing if the stockholders do not profit. If the stockholders do profit, the cost is minor.

Some critics argue also that option gains are a kind of compensation over and above already generous financial incentives for management. This reasoning is hard to follow. We at Ford have long been concerned about the serious and protracted lag in executive compensation before taxes, when compared with the substantial percentage increases in the compensation of hourly employees and salaried employees below executive rank. Inflation and highly progressive income tax rates have greatly aggravated this situation, which is shared, we have reason to believe, by other large companies. The restricted stock option has been an effective means of meeting this problem.

Motivation

Another criticism often heard is that the proprietary interest of an optionee is reduced if the optionee has to sell a portion of his stock to finance the purchase of another block of option stock. This charge, incidentally, is inconsistent with the suggestion that most optionees are already well off. In the first place, the option itself—even before exercise—provides a strong sense of, and motivation toward, proprietorship. To the extent that the option accrues only over a long period of time, this motivation should and does persist. It has been my observation that Ford optionees who have sold some option stock in order to take up further options have retained sufficient shares to maintain a significant sense of ownership.

Much criticism has been leveled at variable price options. I personally do not approve of variable pricing of options for key employees, but there may be a place for them when used in plans that are more closely akin to purchase of stock by broad groups of employees on an instaliment payment basis.

Nor do I believe that, in general, the law should permit the repricing of options or the cancellation of existing options so that they can be replaced with options at a lower price. There may, of course, be situations where substitution of lower price options is justified, as in the case of an option price that has been consistently higher than the market price of the stock for a considerable period of time, thus making it worthless as an incentive. But, in the main, such practices are difficult to defend, and specific corrective steps may be in order.

Disclosure of data

It has been charged that there is inadequate disclosure to stockholders of data on option grants and exercises, executives' benefits from options, and sales of optioned shares. The rules and regulations of the Securities and Exchange Commission and the various securities exchanges require listed companies to furnish or make available to the stockholders a good deal of information on options. For example, the rules governing proxies require that these companies include in their proxy materials to stockholders a statement of all options granted since the beginning of the previous year to the directors and officers as a group and to each individual director and each of the three highest paid officers, together with a statement of the market value of the stock when the options were granted. Similar information also must be given about exercises of options by the directors and officers.

In addition, all purchases—including purchases on the exercise of options—and sales of a company's stock by individual directors and officers must be reported by them monthly to the SEC and to a stock exchange. These reports are open for inspection by the public, and many of the transactions described in them are reported in the press.

Rules and regulations aside, however, it is clear that responsible corporate management should give its stockholders information about stock options in sufficient detail to afford an accurate picture both the manner in which the company is employing options and the number of option grants that have been made. Option data in proxy statements and other reports to stockholders should be in simplified form—generally in tables—and readily understandable. A rule of thumb for management might be simply that the record be made clear and comprehensible.

IMPROVED ADMINISTRATION

There has been much progress in the past decade in administering option plans, in determining their most efficient use, and in detecting and preventing abuses.

As a result of our own experience, Ford Motor Co. has developed policies that we believe are generally sound. We feel such policies can eliminate most of the possible abuses of stock options. Thus—

In our opinion the administration of the option plan should be handled by disinterested directors to insure the protection of the stockholders' interests.

Options should be granted at 100 percent of fair market value.

Except where large grants are necessary to attract a new top executive, options should be granted in relatively small but (when merited) fairly frequent lots.

There should be a relatively long earning-out or accrual period to encourage more sustained effort by optionees for the company's benefit, to lessen the financing problem, and to insure that the optionee continues to merit the option through continued employment.

A sound stock option plan should in no way depend on such things as tax loopholes or provisions of the tax law that would frustrate the intent of Congress or be contrary to basic American principles of fairplay. There undoubtedly are areas in which the tax provisions applying to restricted stock options could be improved. For example, the penalties for unintentional underpricing of options could be modified in the interests of small companies whose stock is not on the market. The provisions relating to the 85 and 95 percent formulas, repricing, and variable price options should also be reexamined.

In any consideration of major tax reform, it is tempting to take sweeping measures designed to simplify and make more orderly the whole tax structure. It is sometimes distressing to tidy minds that the tax system should be used not only to raise revenues but also to provide economic incentives—whether for individuals, by capital gains; for companies, through the fast depreciation write-off; or for the whole economy, by means of proposals to fight recessions by suspending the collection of some taxes for a time. Presumably they want the incentive to be supplied from some other source or by some other means, or they doubt the need of it.

While such feelings are understandable, it seems beyond argument that taxes of the size that we have had and will continue to have must work either as incentives or as disincentives; they cannot be neutral.

CONCLUSION

I believe that stock options are very much in the public interest. If the detractors of monetary incentives had a sufficient appreciation of the importance of good, soundly motivated management to the real interests of all Americans, I am sure they would become as great supporters of the stock option and other incentive devices as they are now detractors. Unfortunately, many such critics are not well informed on the subject. They do not understand that—

Stock options are in the public interest because they encourage good management.

They encourage business executives to work in ways that are most efficient, most productive, most progressive—and thus contribute most to raising people's incomes and living standards.

Stock options also help our society to put and keep our best managers in positions that have the greatest impact on the whole economy.

Stock options, in short, foster both the most efficient use and the most economical allocation of one of our scarcest and most precious national resources—management. And today, more than ever, it is essential that we do wisely and economically allocate that resource.

These are the social justifications for stock options and for the tax treatment accorded them. The restricted stock option is one of several special provisions of our laws that encourage inventors to invent, entrepreneurs to build new businesses, and professional managers to manage wisely and well. Unless some better means can be found to achieve these ends, we should be careful not to impair the means at hand.

Senator GORE. As a matter of fairness to other taxpayers, do you not believe that a corporation official who receives compensation in the form of restricted stock options, should pay taxes on that income at the time the option is exercised?

Mr. GILBERT. I most certainly do, for the reasons which I have expounded this morning.

Senator GORE. And it is not true, as the Treasury representatives have testified, that in many instances fortunes are acquired through the restricted stock option route on which no taxes of any kind, at any time, are paid by this recipient?

Mr. GILBERT. No, he would pay the capital gains tax.

Senator GORE. Suppose that he does not dispose of the stock, but it goes into his estate. Then he, the direct beneficiary, at no time during his life pays any taxes on the fortune, however big it may become?

Mr. GILBERT. That is correct.

Senator GORE. Yet every hourly worker who gets his pay check at the end of the week has the heavy hand of the tax collector laid upon his pay check.

Mr. GILBERT. And we who get cash dividends pay our taxes too on an income basis.

Senator GORE. Do you think this situation lends respect on the part of our citizenry for the tax laws of the country?

Mr. GILBERT. I do not.

Senator GORE. Thank you, Mr. Chairman.

Mr. Chairman, I would like to ask unanimous consent at this point, along with the other insertions, to have an article included from the Vanderbilt Law Review, and also a letter from Prof. Herman L. Trautman, of the Vanderbilt Law School.

The CHAIRMAN. Without objection, the insertion will be made.

(The information referred to follows:)

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EXECUTIVE COMPENSATION: THE TAXATION OF STOCK OPTIONS

JACK D. EDWARDS*

The popularity of the stock option as a method of executive compensation results primarily from its favorable tax consequences. Under present law, an executive's ordinary income may be converted into capital gain. These discriminatory provisions provide a fertile field for tax avoidance.

The first portion of this paper deals with the history of stock option taxation to date. Much of the earlier law remains applicable. The historical perspective shows the wide latitude for avoidance and the faulty assumptions in which tax treatment has been grounded. The second part deals with the present tax treatment of stock options.

I. The Development of Stock Option Taxation

A. Options Before 1950

The history of stock option taxation is the history of a battle between Congress[1] and the lower courts,[2] on one side, against the Treasury, with occasional support from the Supreme Court.[3] Considering the odds against it, the Treasury has been remarkably successful in the struggle, but it has not been able to limit the option to reasonable proportions as an incentive device.

Many different kinds of stock options have been used, but they usually follow this pattern: corporation *C* gives executive *E* an option for a limited time to buy stock in *C*. The price will generally be near the market value, or slightly above it. A gain will accrue to *E* if the market value of the stock rises above the option price during the option period, and he exercises his option at that time. The anticipated gain, then, is the future rise in the value of the stock.

If *E* does make a profit, the tax problem appears. How much of the increment should be taxed? When should it be taxed? Should it be taxed as ordinary income or as a capital gain?

Taxpayers have argued that options are not compensation, but merely sound methods of bringing executives into equity ownership.

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1. The role of a militant Congressman is well-played by Representative Knutson at 93 Cong. Rec. A4060-66 (1947).
2. The extent to which some lower courts have taken up the fight is indicated by the Tax Court decision in Philip J. LoBue, 22 T.C. 440 (1954). See note 66 *infra*.
3. Commissioner v. LoBue, 351 U.S. 243 (1956); Commissioner v. Smith, 324 U.S. 177 (1945).

They have argued further that since stock options are excluded from the statutory definition of ordinary assets,[4] they must be given capital gain treatment. The Treasury has consistently believed that ordinary income rates should apply to the difference between what the employee pays for his stock and the fair market value at the time he receives the stock. This is based on the assumption that the gain represents compensation to the executive. The regulations have taken that position except when court decisions have forced a temporary retreat. These have been the general lines of battle.

The first Treasury statement on the subject in 1923 announced that the Treasury intended to tax any option which had a "substantial" spread at the time of exercise, and that the amount of ordinary income would be measured by that spread.[5] This regulation was repeated, with minor variation, until 1938. During this period from 1923 to 1938, the cases seem to have gone in all directions, with the circuit courts of appeal destroying any semblance of uniformity in the area. As the Board of Tax Appeals viewed it: "We do not think it is possible to harmonize the cases which have been decided."[6] Most of the cases appear to have been decided in favor of capital gain treatment for the taxpayers. Preferential treatment was denied where there was a clear element of compensation. The latter was determined by the motivation of the employer.[7]

Geeseman v. Commissioner,[8] the earliest important case, was decided in 1938. In 1931 the Continental Can Company gave the taxpayer an option to buy stock at $30 per share; the market value at that time was $36. In 1933 he purchased 640 shares when the market value was about $70 per share. The Commissioner proposed to tax him on the difference between the market value of $70 and the purchase price of $30, as ordinary income. The court found little help in the precedents. It said that to hold for the taxpayer on the ground that this was solely the purchase of an asset would be unrealistic; to hold for the Commissioner because this was a simple matter of compensation would be equally unrealistic. Since both elements are always present courts must look to see which aspect is dominant. But at this point the court loaded the scales heavily on the side of capital gain treatment. The option would be characterized as compensation only (1) when the parties had a definite understanding that the option price would be fixed or controlled by services rendered, or (2) when it would be absurd and unreasonable to say

4. INT. REV. CODE OF 1954, § 1221. Sections of the 1954 Code will hereinafter be cited only by section number.
5. T.D. 3435, 1923-II-1 CUM. BULL. 50 (1923).
6. Edward J. Connally, 45 B.T.A. 374, 376 (1941).
7. For a collection of cases, see Annot., 146 A.L.R. 1391 (1943).
8. 38 B.T.A. 258 (1938).

that the option was not compensation. Guided by these principles, the court had no difficulty in finding for the taxpayer, since he had made no promise to remain with the company, and consequently there was no firm agreement as to compensation for future services to be rendered.

After the *Geeseman* decision, the Treasury reluctantly retreated. The regulations under the Revenue Act of 1934[9] and the Revenue Act of 1936[10] were amended by T.D. 4879.[11] This provided that any gain resulting from exercise or sale of the option would be taxable only when the option was in the nature of compensation.[12] It does not appear that *Geeseman* and the resulting regulations had much effect on subsequent court decisions. A later decision of the same court said that the new regulation was merely the statement of a rule already settled by the cases.[13] If there was any effect at all, it was to render even more difficult the task of the Treasury in trying to tax options with elements of compensation.

In 1945, the Supreme Court contributed to the confusion with its opinion in *Smith v. Commissioner*.[14] The taxpayer was employed by Western Cooperage Company, which had taken over the management of the Hawley Pulp and Paper Company under a reorganization plan. When Hawley's indebtedness was reduced by a certain amount, Western was to receive Hawley stock in payment for services. Prior to the receipt of any stock, Western gave the taxpayer an option to purchase Hawley stock if and when it was received. There was a finding of fact that the option had no value at the time of grant, because the market value of the stock did not exceed the option price. Since there was no value to the option when given, and since the arrangement was clearly intended to be compensation, the Supreme Court affirmed the Tax Court in holding that the intended compensation must have been the spread at the time of exercise. The result seems correct, but the logic is hardly satisfying. If an option will probably be financially advantageous in the future, doesn't it have present value even though it cannot be converted into cash at the present time? A future interest in land, to use a simple example, clearly has present value.

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9. 48 Stat. 680 (1934).
10. 49 Stat. 1648 (1936).
11. "[A taxpayer exercising an option shall include in gross income] the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered . . . ." T.D. 4879, 1939-1 Cum. Bull. 159.
12. The courts considered many factors in determining whether the intention was primarily compensatory or proprietary. See Rudick, *Compensation of Executives Under the 1954 Code*, 33 Taxes 7, 26 (1955).
13. Springfield v. Commissioner, 41 B.T.A. 1001, 1009 (1940).
14. 324 U.S. 177 (1945).

Encouraged by the *Smith* case, the Treasury returned to a stricter policy in dealing with options. T.D. 5507[15] reverted to the position of the earlier regulations in providing that all options would be considered compensation and would be taxed on the spread at the time of exercise. It went further than the early regulations in eliminating the "substantial" spread requirement. T.D. 5507 applied only to options granted after Feb. 26, 1945, the date of the *Smith* decision. I.T. 3795[16] was released at the same time, providing that options granted prior to that time would not be taxed as compensation unless (1) there was a substantial spread at the time of grant, or (2) compensation was found under the old formula.

The new regulation and ruling were not very significant in their effect on the case law. The second part of I.T. 3795 was intended to cover options granted prior to *Smith*. In *Otto C. Schultz,*[17] the court carefully described the two possible bases of liability under I.T. 3795, but didn't have to worry about the ruling because it found compensation under the old regulations. In *Abraham Rosenberg,*[18] the court did not mention the first basis of taxability (*i.e.*, a substantial spread at the time of grant), though it would not have affected the result in that case. But in *Commissioner v. Straus,*[19] the court ignored I.T. 3795 completely, finding no deficiency. Since the option price in that case was $6 per share and the fair market value at the time of grant was $23.75 per share, an application of I.T. 3795 would certainly have reversed the result.

While those who were litigating past cases went along as usual, those who were planning for the future were faced with T.D. 5507, taxing all options as ordinary income upon their exercise. Most people felt the regulation was not valid and would not be upheld. It was often ignored. One taxpayer added insult by using the regulation as a major premise in his argument.[20] Regardless of what else it accomplished, this attack by the Treasury must have had a considerable *in terrorem* effect.[21] Since there still was doubt as to what the state of

15. 1946-1 CUM. BULL. 18.
16. 1946-1 CUM. BULL. 15.
17. 17 T.C. 695 (1951).
18. 20 T.C. 5 (1953).
19. 208 F.2d 325 (7th Cir. 1953).
20. Commissioner v. Stone's Estate, 210 F.2d 33 (3rd Cir. 1954). The taxpayer purchased 100 warrants from his employer, paying $1,000 for the warrants. Each warrant permitted the purchase of 100 shares of stock. He estimated that he received $5,000 compensation in this transaction, and he paid a tax on that amount. The market price of the stock was below the option price when the warrants were purchased. Later the price went up, and the taxpayer sold 89 of the warrants for $82,680. He argued that T.D. 5507 requires the recognition of ordinary income when property is transferred; since he had reported $5,000 when the warrants were transferred, the remainder of the gain must be a capital gain. The argument was sustained.
21. See the cries of anguish relayed by Rep. Knutson to his fellow legislators, 93 CONG. REC. A4060-66 (1947).

the law was, the taxpayers moved to Congress for support.

B. Options Since 1950

Stock options branched into two families in 1950. Pressure on Congress for more favorable treatment resulted in an amendment to the Internal Revenue Code of 1939, section 130A,[22] which is carried forward, with some modifications, in the present law.[23] Options qualifying under this provision were labeled restricted stock options. Other options are often referred to as non-restricted stock options.[24]

1. *Restricted Stock Options Under Section 421.*—[25]The basic purpose of section 421 is to provide capital gain treatment (i.e., preferential rates and a tax only at the time of disposition of the stock) for options which are considered to be incentive devices. To insure the fact that the option is truly "incentive," and to prevent abuse, several restrictions must be placed on it. They may be summarized as follows:[26]

(a) The option price must be at least 85% of the fair market value at the time of grant.[27] Under a variable pricing provision, the option will qualify if (1) the purchase price varies only with the value of the stock, and (2) the option price is at least 85% of the fair market value when the option is granted.[28]

(b) The option must be non-transferable, except on death.[29]

(c) The recipient cannot hold more than 10% of the voting stock in the corporation when the option is granted.[30] This requirement is waived if the option price is 110% of the fair market value at grant, and the option is exercisable for only 5 years, or was exercised by Aug. 16, 1955.

(d) The option must not be exercisable more than 10 years from the time it is granted.[31]

(e) The recipient must be an employee when the option is granted;

22. Int. Rev. Code of 1939, § 130A, added by 64 Stat. 942 (1950).
23. § 421.
24. This seems an unfortunate name since many "non-restricted" options are severely restricted. To prevent confusion, this paper refers to all options which do not qualify under § 421 as "non-statutory" options.
25. This is a cursory glance at § 421, which, of course, is extremely important; it has been amply commented upon in various writings. See Rudick, *supra* note 12.
26. For simplicity all numbers in this section are from the INT. REV. CODE OF 1954. For an excellent treatment of the minor changes made in 1954, see Rudick, *supra* note 12.
27. § 421(d)(1)(A)(i).
28. § 421(d)(1)(A)(ii).
29. § 421(d)(1)(B).
30. § 421(d)(1)(C).
31. § 421(d)(1)(D).

and it must be exercised while he is an employee or within three months thereafter.[32]

If an option qualifies as a restricted stock option, it will be treated as a capital asset, and given preferential treatment, subject to the following conditions:

(a) No disposition of the shares may be made within two years of the grant of the options or six months of exercise.[33]

(b) If the option price is between 85% and 95% of the fair market value at the time the option is granted, there will be ordinary income to the extent of the option price subtracted from the lesser of (1) the fair market value of the shares when the option was granted, or (2) the fair market value of the shares upon their disposition.[34]

These are the basic provisions of section 421. It is quite detailed, covering modifications of the option, exercise by an estate,[35] and effects of options received pursuant to certain corporate transactions. The regulations under section 421 are long and cover the possible problems in even finer detail. This paper will not deal with the various considerations involved in setting up such a plan.

There have been no court decisions dealing with section 421 thus far. It may be expected that they will not arise frequently; since the success of a 421 plan is assured, a person in a high tax bracket is not encouraged to leave the friendly confines of capital gain treatment in order to test the fringe areas of section 421. If he wants to gamble, a non-statutory option with no pretence of qualifying under section 421 is a more likely windfall.[36]

2. *Non-Statutory Options.*—The cases since 1950 have involved options exercised prior to 1950. Various factors determined their outcome, and the cases might be grouped as follows:

(a) Some options were taxed on the spread which existed at the

32. § 421(a).
33. § 421(a).
34. § 421(b).
35. § 1014(d) provided that the basis of a restricted stock option would not be stepped up at the death of the holder if he had not exercised the option by that time. This made it desirable to exercise the option before death. This provision has recently been deleted, so there is a step-up regardless of exercise. 72 Stat. 4 (1958). There is a continuing drive to liberalize tax treatment upon the employee's death. Under a proposed amendment to § 421, any ordinary income arising from the exercise of an option by an employee will not be due until the death of his spouse, assuming she receives the stock. The proposed change has been passed by the House of Representatives. H.R. 6777, 86th Cong., 1st Sess., 105 CONG. REC. 15541-42 (daily ed. Aug. 25, 1959).
36. This is indicated by the names of recent articles: *The Non-Restricted Employee Stock Option—An Executive's Delight*, 11 TAX L. REV. 179 (1956); *The Valuation of Option Stock Subject to Repurchase Options and Restraints on Sale: A New Tax Bonanza in Executive Compensation*, 62 YALE L.J. 832 (1953).

time the option was granted. In *McNamara v. Commissioner*,[37] the Court of Appeals for the 7th Circuit taxed the spread at time of grant instead of the spread at time of exercise, basing its decision on the intention of the parties. The stock had an ascertainable spread of $3 at grant and about four times as much at exercise. The court seemed confused about the economics of the situation.

> But it seems equally clear to us that if we say, from this evidence, that it was the intention of the parties that the grant of the option was to constitute compensation, we must also say that the parties intended it as additional compensation for petitioner's services for the year in which the option was granted.[38]

Just because the option was intended to be compensation in the year it was granted does not mean that the spread at that time determines the amount of gain. It seems clear that there might be value received, and hence compensation, even where there was no spread whatsoever at the time of grant. There was no reason to limit the gain in this case to the spread when the option was granted.

The taxpayer also prevailed in *Commissioner v. Stone's Estate*.[39] He purchased warrants from his employer corporation. Each warrant was an option to buy 100 shares of stock. He paid tax on the warrants when he received them, estimating the gain at $5,000. He later sold the warrants for $82,680, and claimed a capital gain. The court upheld his claim and here again the decision seems unwise. The Commissioner has much the better of the argument in pointing out that the transaction between the corporation and the taxpayer was not in the nature of a sale, and that ordinary income should not be converted into capital gain through this sham.

(b) Some cases held no income at either grant or exercise on the basis of the old compensatory-proprietary approach. While it has been suggested that proprietary options were gaining increasing favor with the courts during this period,[40] this would seem hard to support. No clear judicial attitude is discernible. The option in *Robert A. Bowen*[41] had a spread of $33 per share at the time of grant, and yet was held proprietary. This result is difficult to understand, in view of the large element of immediate gain. *Abraham Rosenberg*,[42] on the other hand, was a strong case for the proprietary argument. The employer corporation was closely held, and the only way for the taxpayer to assure himself of an equity interest was by way of

37. 210 F.2d 505 (7th Cir. 1954).
38. *Id.* at 506.
39. 210 F.2d 33 (3rd Cir. 1954).
40. Lentz, *Stock Ownership Plans—Options, Warrants, Leverage Stock*, N.Y.U. 13TH INST. ON FED. TAX. 499, 519 (1955).
41. 13 T.C.M. 668 (1954).
42. 20 T.C. 5 (1953).

an option. Furthermore, the stock had a fair market value of about $3.00 or $3.25 when the option was given at $5.40. Several other cases lie somewhere between *Bowen* and *Rosenberg*, with regard to the element of compensation contained in the bonus.[43]

(c) Many cases found ordinary income at the time of exercise because the options were compensatory. In *Charles E. Sorenson*,[44] Willys Motor Co. gave the taxpayer very lucrative options to lure him into its management. The options were an important part of his demands in the pre-employment negotiations. These facts tended to show compensation. An additional factor which hurt the taxpayer's case was his desire to sell the options, rather than exercise them, and a failure to show that he had ever intended to buy and retain an equity interest in the firm. Once the court decided that the intention was compensatory, it followed the reasoning of *Commissioner v. Smith:* compensation was intended, but restrictions on the option prevented its having an ascertainable market value at the time it was granted, so the spread at exercise must have been the intended compensation.

In *Joseph Kane*,[45] the option was given to the wife of the taxpayer when he started working for his new employer. The court had little difficulty in treating the option as one belonging to the husband. Though the option price was above fair market value at grant, the price rose sharply so that considerable gain resulted upon exercise of the option.

The option in *Dean Babbitt*[46] was subject to restrictions which prevented valuation at the time of grant. The court found the intention compensatory, and measured the gain by the spread at exercise. The case also illustrates the computation problem involved in bloc sales. Since there was very little trading in the stock, a large bloc thrown on the market would have depressed prices. Consequently, the market value of the bloc was not determined by the quoted market price but rather the estimated price of the entire bloc had been offered.

Other cases during this period took the same approach, and found ordinary income at exercise of the option.[47]

(d) Some cases refused to tax the option at exercise because restrictions prevented valuation. The leading case here is *Harold H. Kuchman*.[48] At the time of both grant and exercise in this case,

43. Commissioner v. Straus, 208 F.2d 325 (7th Cir. 1953); Donald B. Bradner, 11 T.C.M. 566 (1952), *aff'd per curiam*, 209 F.2d 956 (6th Cir. 1953); James C. Hazleton, 12 T.C.M. 398 (1953).
44. 22 T.C. 321 (1954).
45. 25 T.C. 1112 (1956).
46. 23 T.C. 850 (1955).
47. John C. Wahl, 19 T.C. 651 (1953); Otto C. Schultz, 17 T.C. 695 (1951).
48. 18 T.C. 154 (1952).

there was a complicated reorganization taking place. The terms of the option prohibited resale by the taxpayer for a year and gave the vendors the first right of repurchase. The latter right ran for two years. The Tax Court found that the fair market value of the stock at the time of exercise could not be ascertained and consequently it found there was no tax due at that time. It did not consider if and when a tax might be due. The difficulties in this holding will be discussed later.

In *Phil Kalech*,[49] the court did sustain a tax at exercise, but used book value rather than market value to compute gain, because of restrictions on the option.

(e) In a final group of cases, the question was whether the taxpayer had received ordinary income at the time when restrictions on the stock lapsed. In these cases, no tax had been assessed at the time of exercise, presumably on the ground that no valuation was possible because of the restrictions. The courts rejected the Commissioner's position that the lapse of restrictions might be a taxable event.

In *Robert Lehman*,[50] the taxpayer was a partner in Lehman Bros. The partnership received options for certain services rendered, and exercised them on Feb. 1, 1943. There were certain restrictions, not described in the option, attached to the stock. The restrictions lapsed at the end of that year. The partnership did not include as income the gain resulting from exercise of the option. The Commissioner asserted a deficiency against the taxpayer for his share of the profits, claiming ordinary income was received when the restrictions lapsed. The court held for the taxpayer, saying:

> Termination of the restrictions was not a taxable event such as the receipt of compensation for services or the disposition of property. Values fluctuate from time to time and the value on a later date might be out of all proportion to the compensation involved in the original acquisition of the shares. The gain was properly reported as a long term capital gain from the subsequent sale of the shares.[51]

In this case, stock restrictions lasting only 11 months turned ordinary income into capital gain. It would take a greedy taxpayer to complain about that sort of bargain.

The *Kuchman* and *Lehman* cases combine to form a possible road, albeit a winding road, to avoidance of all tax at ordinary income rates. *Kuchman* said no tax was due at exercise if restrictions prevented valuation. Lehman held there was no tax liability upon lapse of restrictions. The apparent result of the transaction is no tax until

49. 23 T.C. 672 (1955).
50. 17 T.C. 652 (1951).
51. *Id.* at 654.

sale of the stock and a capital gain at that time. If the short-term restrictions which worked the magic in *Lehman* are found to be sufficient in the future, the arrangement is not at all burdensome to the taxpayer.[52]

Another case dealing with the *Kuchman* problem has recently spent several years in the courts. Household Finance Corporation offered a stock option plan to the taxpayer. The Tax Court held it was compensatory.[53] In doing so, it rejected two claims that valuation was impossible: (1) The taxpayer argued he had promised not to sell the stock as long as he was employed by the corporation, but the court found there was no binding agreement, and consequently no diminution in value. (2) It was argued that there was possible liability under section 16(b) of the Securities Exchange Act of 1934.[54] If the taxpayer might later be forced to disgorge his entire profit pursuant to that statute, it would not be fair to tax this profit when it is only temporarily realized. The Tax Court decided that no profits were vulnerable under that statute. Consequently, the deficiency asserted was upheld. Upon petition for review, the Court of Appeals for the Seventh Circuit reversed.[55] It said a binding agreement not to sell did exist, and liability under section 16(b) of the Securities Exchange Act of 1934 was likely if the stock had been sold within six months.[56] This prevented valuation and no tax could be levied.

The *MacDonald* case then started its second round in the Tax Court.[57] On motion for additional hearing, counsel for the Commissioner offered some possible bases upon which economic gain could be measured, though he stated that there was no intention to limit the government's proof at retrial. He suggested: (1) The corporation gave the taxpayer a fifteen year interest-free loan to the extent of the purchase price of the stock, plus any tax due on the purchase. The economic gain involved in this preferential treatment was taxable compensation.[58] (2) The taxpayer supplied enough money to buy

52. Of course the restrictions might be burdensome for non-tax reasons.
53. Harold E. MacDonald, 23 T.C. 227 (1954).
54. 48 Stat. 896 (1934), 15 U.S.C. § 78(p) (1952).
55. 210 F.2d 505 (7th Cir. 1954).
56. At the present time, it is clear that option profits are not within the reach of § 16(b) of the Securities Exchange Act of 1934, provided the options are non-transferable and meet certain procedural safeguards. 17 C.F.R. § 240.16(b) (1949).
57. 16 T.C.M. 208 (1956).
58. Transcript of Record, p. 6, reproduced in Appendix A of Brief for the Petitioner, p. 25, Commissioner v. MacDonald, 248 F.2d 558 (7th Cir. 1957). A similar argument was made on appeal. Brief for the Petitioner, p. 17, Commissioner v. MacDonald, *supra*. The taxpayer argued that this type of gain was too speculative, and the interest-free aspect of the note was not something that could be sold, so no ascertainable value was present. Transcript of Record, p. 17, reproduced in Appendix A of Brief for the Petitioner, p. 33, Commissioner v. MacDonald, *supra*. The argument of the taxpayer is not persuasive. On petition for review, Brief for Respondents, p. 37, Com-

5,541 shares at market price. The other 4,459 shares represented gain realized because of the spread between purchase price and market price. Dividend yield was about $? per share. Capitalizing this expected return would give a value in excess of $150,000. This is taxable gain.[59]

Judge Rice in the Tax Court was clearly unhappy with both the Seventh Circuit holding,[60] and the attempts to find different methods of valuation.[61] He denied a new hearing.[62]

On petition for review, the Court of Appeals for the Seventh Circuit again reversed.[63] It said the previous decision which it had rendered gave the Commissioner a chance to use other methods of valuation. Consequently, the Tax Court was required to hear the possible methods. A third Tax Court decision has not been given.

The *MacDonald* litigation may reinforce conflicting positions. It buttresses the *Kuchman-Lehman* avoidance plan insofar as it holds that the option restrictions prevent ordinary income at exercise. On the other hand, it indicates that the courts are worried about possible tax-avoidance. It also emphasizes that the Commissioner is not conceding the battle. As the executive plans his future forms of income, he may not be encouraged by the taxpayer's success in *MacDonald*.

3. *Philip J. LoBue.*—[64] This case has been the most important judi-

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missioner v. MacDonald, *supra*, the taxpayer emphasized Rev. Rul. 55-713, 1955-2 CUM. BULL. 23. This states that where an employer provides an interest-free loan for premiums on an employee's life insurance policy, no taxable income is received by the employee. But the Treasury is careful to limit revenue rulings to similar facts, and an extension of the ruling to this situation could not be justified. Furthermore, the issue in the ruling concerns whether or not there was any gain. But here the two courts have agreed that there was an economic gain in the transaction; the problem is one of valuation, and whether or not the interest-free loan is relevant to that determination.

59. Transcript of Record, pp. 7-8, reproduced in Appendix A of Brief for the Petitioner, p. 26, Commissioner v. MacDonald, *supra* note 58. On appeal, the Commissioner either put the argument in extremely general terms, or abandoned it. Brief for the Petitioner, pp. 17-18, Commissioner v. MacDonald, *supra* note 58. This method of measuring gain does not seem acceptable. The argument is, in effect, that 5,541 shares represent basis, and 4,459 shares represent gain. The gain is then capitalized on the basis of expected earnings. Were the restrictions taken into consideration when the rate of capitalization was determined? If not, then it seems the Commissioner has changed the method, but retained the basic flaw. If the restrictions were taken into account in some manner, the capitalization rate of about 16.8 (a return of less than 6%) seems much too high.

60. He commented at the hearing: "It does seem to me though, that the 7th Circuit has opened up a pretty big loop-hole in the law here." Transcript of Record, p. 9, Commissioner v. MacDonald, *supra* note 58.

61. "We are unable to find that there is any method of computation, other than the one used in our original opinion, which is proper or meritorious and the respondent's motion for an additional hearing in this cause is hereby denied." Harold E. MacDonald, 16 T.C.M. 208, 209 (1956).

62. *Id.* at 208.

63. 248 F.2d 562 (7th Cir. 1957).

64. 22 T.C. 440 (1954).

cial pronouncement in the stock option area. It began as a typical proprietary-compensatory controversy. The Michigan Chemical Corporation gave the taxpayer options in 1945, 1946, and 1947. The options were not restricted. The options were exercised in 1945 and 1946 for the grants given in those years, and the Commissioner asserted a deficiency. The only witness at the hearing before the Tax Court was a Colonel Davis, who had been the chief executive officer of the corporation during the years in question, and had drawn up the option plan. He indicated on direct examination that the plan was purely an incentive measure.[65] On cross-examination, however, a portion of a letter of Colonel Davis to the taxpayer was placed in the record, and it sounded very much like a salary bonus plan.[66] The Tax Court rejected the validity of T.D. 5507. It then held that the option was an incentive device and denied the deficiency. On petition for review, the Court of Appeals for the Third Circuit affirmed.

The long-standing controversy was then placed before the Supreme Court.[67] The result was a victory for the Commissioner's patience and persistence.[68] Mr. Justice Black, for the majority said:

> But there is not a word in Sec. 22(2) [of the Int. Rev. Code of 1939] which indicates that its broad coverage should be narrowed because of an employer's intention to enlist more efficient service from his employees by making them part proprietors of his business. In our view there is no statutory basis for the test established by the court below. When assets are transferred by an employer to an employee to secure better services they are plainly compensation. It makes no difference that the compen-

65. "Q: In these discussions with the directors and with the officers of the company, prior to the passing of the resolutions of March 21, 1944, was there any characterization of the plan in your recollection as being intended as compensation to the employees?"
"A: Not the slightest." Transcript of Record, p. 129, Commissioner v. LoBue, 351 U.S. 243 (1956).

66. One paragraph read: "The Committee's selection of the names of our employees to receive the right to purchase stock and the number of shares assigned to each selectee is determined by the Committee after a careful appraisal of the individual's contributions to the company in the way of job performances during the past year. In other words, the extent of your participation in the plan is based on how well you handled your job during the year. Outstanding service to the company is given added recognition in determining the number of shares assigned. In this connection I would like to point out to you it is but natural to expect a more rigid comparative appraisal of your efforts in the future." Transcript of Record, pp. 135-136, Commissioner v. LoBue, *supra* note 65. And one of the letters in exhibit contained this sentence: "This allotment of stock was made by the committee and is in recognition of your contribution and efforts in making the operation of the company successful." *Id.* at 19. Yet in the Tax Court opinion, Judge Rice said: "Here it definitely and clearly appears that the granting of the options to petitioner in 1945, 1946 and 1947 was not intended as additional compensation for his services." 22 T.C. 440, 445 (1954).

67. 351 U.S. 243 (1956).

68. "Its victory in the now famous LoBue decision can well be characterized as a situation where the Treasury lost every battle but won the war." Cohen, *The Stock Option Picture Since LoBue; Supreme Court's Views Turn Up in New Regs.*, 6 J. TAXATION 17 (1957).

> sation is paid in stock rather than in money.[69]

This quite clearly closed the case against the proprietary theory. Until that point, the Supreme Court had responded well. But then Mr. Justice Black discussed the time when the gain should be measured, and the result was less satisfactory. In this case, the gain was measured at exercise because at the time of grant there were certain restrictions on the option preventing valuation.[70] But Mr. Justice Black said:

> It is of course possible for the recipient of a stock option to realize an immediate taxable gain. See *Commissioner v. Smith*, 324 U.S. 177, 181-82. The option might have a readily ascertainable market value and the recipient might be free to sell his option.[71]

Here the court gave a boost to the *McNamara* approach[72] for converting ordinary income to capital gain. If a corporation is careful to make the option transferable, and to eliminate all other restrictions so as to give the option an ascertainable market value, only the spread at the time when the option is granted will be taxed. Thus the amount of ordinary income can be completely controlled, and all appreciation from that point until exercise will be capital gain.[73] Once again, as in the *Smith* case, the Supreme Court lost a good opportunity to eliminate much of the difficulty in this area.[74]

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69. 351 U.S. 243, 247 (1956).

70. Mr. Justice Black said that the stock was not transferable, and the right to buy was contingent on his remaining an employee until exercise of the options, 351 U.S. 243, 249 (1956). The second restriction is not clear on the record. Transcript of Record, pp. 18-22, Commissioner v. LoBue, *supra* note 65.

71. 351 U.S. 243, 249 (1956) (dictum).

72. See text accompanying note 37 *supra*.

73. It is interesting to note that this is almost the reverse of the *Kuchman-Lehman* device (see text accompanying notes 48-52 *supra*). Under that plan, the taxpayer attempts to place such restrictions on the option and the resulting allocation of stock that valuation becomes impossible. If both of these methods gain the approval of the courts, the tax law will be doubly beneficent—it not only will give capital gain treatment to most or all of the gain, but will give a choice of plans to fit the needs of the corporation.

74. The other question in the case concerned the determination of the year of exercise. The taxpayer gave notes to the corporation in 1945 and 1946; he paid them in 1947 and received the stock at that time. The Tax Court stated that he received the "economic benefit" from the options when the notes were given, so that was held to be the time of exercise. 28 T.C. 1317 (1957). The court relied on James S. Ogsbury, 28 T.C. 93 (1957). In that case the taxpayer gave notice in 1945 that he elected to exercise the option. The terms of the option permitted him to delay payment indefinitely, provided he remained employed by the corporation. In 1948 he tendered payment and received the stock. The Tax Court held that 1945 was the year of exercise, and should provide the measure for taxation. In the *Smith* case, the option was given by Western Cooperage Company for shares in Hawley Pulp and Paper Co. which Western was managing under a reorganization plan. The taxpayer paid for the shares in 1938 and received them in 1939. The Supreme Court held that 1939 was the year of exercise. It stated that since Western did not have an unconditional right to the Hawley stock, the taxpayer did not have an unconditional right to the fruits of the option.

The limits of the *LoBue* holding have not yet been tested. In *James S. Ogsbury*,[75] which was pending when *LoBue* was handed down, the taxpayer abandoned his argument that no compensation was involved. As to the dictum in *LoBue* concerning taxation at the time the option is granted, it has not been at issue in any case since that decision.

II. Stock Option Taxation for the Future

A. The Difficulties with Present Treatment

Certain forms of income are treated as capital gains and are given a highly preferential rate. Several reasons have been advanced to justify this preferential treatment. Each reason is highly controversial. The following section will assume the validity of the major reasons and will consider their application to stock options.

It has been suggested that capital transactions are given preferential treatment because frequently there is no gain or loss in terms of real income, in spite of a sale price which differs from the cost basis. This is the case where a change in interest rates or price levels has occurred.[76] This reason for preferential treatment does not apply to stock options, since the outlay for the investment is not due until the stock is actually received. In those few cases where the receipt of the stock is delayed, the amount of time elapsed will not be a significant factor.

A second suggested reason stems from the fact that capital gains are realized only when the taxpayer elects to realize them. He may decline to realize a gain because his relative position would not be improved after the realization of the gain and the payment of a tax on that gain. Thus the tax on these gains must be favorable or it will tend to freeze realization.[77] This problem is not present in the stock option situation. No investment is made until the option is exercised, so there is no "locked-in" effect. If the stock is later resold by the optionee for a price exceeding the value at the time when the option was exercised, then this justification for preferential treatment may become relevant as to the difference between value at

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The taxpayer won in *LoBue* and *Ogsbury*, but lost in *Smith*. Yet it seems that *Smith* is the strongest case for the taxpayer. There he actually paid out cash at the earlier time, and his investment was complete regardless of when he received the stock. In *LoBue* and *Ogsbury*, on the other hand, there was only a promise to pay. Since enforcement of the promise depends on action by the corporation against the executive, the firmness of the obligation is somewhat doubtful.

75. 28 T.C. 93 (1957).

76. Seltzer, The Nature and Tax Treatment of Capital Gains and Losses, 93 (1951).

77. Testimony of Walter W. Heller, *Hearings Before The Subcommittee on Tax Policy of the Joint Committee on the Economic Report*, 84th Cong., 1st Sess. 318 (1955).

time of exercise and value at time of resale. It is not relevant, however, to the gain arising from exercise of the option.

A third reason for preferential treatment, closely related to the reason just presented, is that a sensitive area of incentive is involved, and the financial world demands a tax law which does not throw roadblocks in the way of investors.[78] Preferential treatment encourages the investment of money in new and expanding industries, according to the argument. Here again, stock options simply do not fit the rationale. Options are a method of executive compensation, and incentive is built into the option device regardless of tax aspects. When the value of the stock rises above the option price, it becomes profitable to exercise the option in nearly every case. Tax incentive will do little to encourage exercise of options, nor will disincentive have much effect in discouraging exercise.[79]

A fourth reason advanced for preferential handling of capital gains is that the gain accrues over several years, but is realized in one year, and the bunching effect increases the tax liability.[80] This is certainly a problem, but with regard to stock options two factors tend to mitigate this apparent inequity. First, the taxpayer has complete control over realization of the gain, and can exercise his options in a way that will prevent too much bunching. Second, options may be given for several years, so that the gains will tend to average out over the years.

If these are the reasons for preferential treatment in capital transactions,[81] that treatment is not justified when applied to stock options.

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78. Testimony of J. Keith Butters, *Hearings*, *supra* note 77 at 316-17.

79. The case for preferential treatment in order to promote incentive is strongest where the goal is not executive compensation, but the sale of stock to a large number of stockholders for the purpose of equity financing. For example, it has been asserted that this form of financing is essential to large, rapidly-expanding corporations, and that a spread at the time the option is granted is necessary to insure the success of the offering. *Hearings Before the House Ways and Means Committee*, 83rd Cong., 1st Sess., pt. 1, topic 15, at 409 (1953). It was argued that the lack of preferential treatment would severely hamper the sale of the issue. This presents the strongest case for advocates of capital gain treatment. Whether or not this form of equity financing is as necessary as the argument suggests is a difficult economic question. A recent study of private investment capacity would seem to cut against the argument. See generally BUTTERS, THOMPSON & BOLLINGER, INVESTMENTS BY INDIVIDUALS (1953). And Dr. Butters has pointed to the drive by the income-minded and security-minded for less risky investments—which would describe American Telephone & Telegraph, the corporation in the above situation. *Hearings*, *supra* note 77, at 316. In any event, the option for equity financing would seem fairly rare, when compared to compensation options, and any incentive advantage involved in preferential treatment for the former would be far outweighed by the disadvantages when applied to the latter.

80. Testimony of Walter W. Heller, *Hearings*, *supra* note 77 at 318-19. But see the testimony of Stanley S. Surrey, *Hearings*, *supra* note 77, at 320, arguing that the averaging problem is largely irrelevant in determining whether or not a preferential rate is justified.

81. For the view that preferential treatment is based on no ecomonic

These general economic considerations may be stated more specifically in terms of horizontal equity. The failure to include option profits in ordinary income is discrimination in favor of the managing class. The income tax is intended to be a "neutral" tax in the sense that all people with the same amount of income shall have an equal tax liability. This principle is violated when a segment of the taxpaying public can claim preferential treatment for part of its earnings.[82] The argument is made that stock option gains are really different from the usual salary gain. But a tax on the spread at the time of exercise is levied only on gain actually received in the form of stock value, and not potential gain; the tax is on the equivalent of dollars received. The taxpayer has no funds invested until the time of exercise. From the tax standpoint, any difference between value received under an option and value received under a straight salary would not seem significant. Under present law, an executive may receive a large tax benefit by shifting the form of his compensation.

The present law particularly favors managers of large corporations. Besides discrimination on behalf of the manager class, preferential treatment for stock options results in discrimination within the class. It is much easier for executives of a large corporation to take advantage of capital gains treatment. Small corporations may have a difficult time showing the fair market value of their stock. This determination is essential under section 421.[83] There is always the danger that the Commissioner may come in and dispute the value, which upsets the plan long after it has been relied upon by the corporation and taxpayer. This discourages the use of section 421 by small corporations.

Determination of fair market value is likewise essential under the *McNamara* approach. Where the option had an ascertainable market value at the time of grant, the option was taxed at that time, but the difference between value at grant and value at exercise qualified as capital gain. This may be desirable for the executive under some circumstances. Here, too, the small corporation is at a comparative disadvantage.

The executives of small corporations are also in a less favorable position because restricted options under section 421 are limited to individuals who own not more than 10% of the voting power of the corporation.[84] Where the corporation is small, the same subparagraph

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rationale whatsoever, but is merely an uneasy compromise between opposing philosophies, see the testimony of Carl S. Shoup, *Hearings*, *supra* note 77, at 319.

82. See Paul, *Erosion of the Tax Base and Rate Structure*, 11 TAX L. REV. 203, 213-16 (1956). The article is an excellent discussion of how equity is disappearing from the income tax.

83. § 421(d)(1).

84. § 421(d)(1)(C).

contains an exception to this rule which may become operative; this provides that where the option price is at least 110% of the fair market value when the option is granted, and the option is either limited to five years or actually exercised in one year, capital gain treatment will be given. This may aid the small corporation executive in some cases, but it is not so desirable as the usual section 421 situation.

Finally, the attractiveness of capital gain treatment has encouraged the use of faulty assumptions to justify preferential treatment.[85]

(a) One assumption was apparently put to rest in *LoBue*—that stock options are "proprietary" or "compensatory" and only the latter should be taxed. Prior to *LoBue*, the courts did not say that options are all one or the other,[86] but they did base their decisions on the relative weights of these two "characteristics." Tax treatment should follow from the nature of the taxpayer's receipts and not be based on the motives of his employer.[87] Whether his employer hates him or likes him is not important; a fortiori it is not important whether he likes him retrospectively (compensation) or prospectively (proprietary interest).

(b) A premise which is equally false is the view that the only compensation in the exercise of an option may be the spread at the time of grant. This was the basis for the decision in *McNamara v. Commissioner*.[88] It was given a further boost by the dictum in *Commissioner v. LoBue*.[89] If the *LoBue* case did away with the compensatory-proprietary distinction, as it apparently did, then the important consideration is how much is received by the taxpayer. It seems apparent that an unrestricted option for any term must be worth something more than the spread when it is granted—indeed, the possibility of appreciation is the principal reason for using the stock option device. It does not make sense to fix the value without regard to that factor.

(c) Some courts assume that appreciation between grant and exercise merely indicates a shrewd purchase. Others have accepted the contention that the appreciation reflects an increase in the executive's

85. For a cogent statement of what we know and what we don't know about the use of stock options, see Erwin N. Griswold, "The Mysterious Stock Option," 2 Tax Revision Compendium 1327. These materials were submitted before the House Committee on Ways and Means, 86th Cong., 1st Sess., 1959, on November 16, 1959.

86. Geeseman v. Commissioner, 38 B.T.A. 258, 263 (1938).

87. This distinction has not been carefully recognized in many of the cases already discussed. Confusion can also be seen in much of the testimony before Congress where the problem is frequently analyzed from the point of view of the corporation, instead of the taxpayer.

88. 210 F.2d 505 (7th Cir. 1954); see discussion in text accompanying note 37 *supra*.

89. 351 U.S. 243, 247 (1956).

output resulting from the incentive created by the option. These views seem naive in light of the inside information, and sometimes inside control, which executives have.[90] There may be contracts to buy or sell which are not publicly known. There may be trends in the market or the industry which are discernible only to those with access to company records. There may be lucrative stock splits.[91] To treat a company executive as if he were in the same position as anyone else buying stock of that company is not realistic.

B. Suggested Changes in Option Taxation

It appears that the present taxation of the stock option is neither equitable nor necessary in terms of economic incentive. The following section deals with some possible solutions to the problem.

1. *Statutory Change.*—The most desirable solution of the problem is a statutory revision which would end all preferential treatment for stock options. This would involve the elimination of section 421. In view of the present uncertainty it should be specifically stated that ordinary rates will apply to the gain realized through the exercise of an option. As an alternative, the tax might be levied on the value of the option itself, regardless of whether or not it is exercised, but this would have two major drawbacks. First, the fair market value of an option is frequently impossible to determine. Second, the tax might be due before any gain could be realized; furthermore, the amount of the tax would be quite independent of the taxpayer's actual gain on the total transaction. Gain is best measured by the spread at the time when the option is exercised.

A complete end to preferential treatment for option profits is desirable. Economic considerations do not require preferential treatment. Giving them such treatment does violence to principles of equity, and is an unnecessary drain on treasury receipts.

2. *Judicial Handling.*—Until a statutory change occurs, it is up to the courts to maintain the greatest possible equity within the framework of the statute. *Commissioner v. LoBue* was a big step in the right direction. Two other areas of attack are suggested:

90. The approach in the securities field seems more realistic. Under § 16(b) of the Securities Exchange Act of 1934, 48 Stat. 896, 15 U.S.C. § 78(p) (1952), an insider is liable for short term profits in company stock without regard to motive, intent or knowledge. This is considered necessary because of the insider's extremely advantageous position, and the difficulty of proving his use of that position. While the considerations in the securities field are not strictly analogous to those in the tax law, the latter might profitably incorporate a similar recognition of the economic facts of life.

91. In Joseph Kane, 25 T.C. 1112 (1956), the option price was above the market price when the option was granted. Less than a year later, there was a stock split. Six months after that, the fair market value was twice as much as the option price. While the effect of the split on the market value is not shown, it can be assumed that the split was not harmful.

(a) It has frequently been assumed that section 130A[92] did not affect the treatment of non-statutory options in any way.[93] It is submitted that section 130A and its successor, section 421 should be held to pre-empt the field of preferential treatment for stock options.

It appears from the *Senate Report*[94] that the restrictive provisions of section 130A were included in the belief that they were essential elements of an incentive option. The section was elaborately designed to exclude options which were not considered to be given for proprietary purposes. Restricted stock options must meet certain tests involving the spread at time of grant, the periods during which the stock is held, the extent of the executive's interest in the corporation, etc. Non-statutory options do not need any of these restrictions. It would be unwise policy to give the same preferential treatment to non-statutory options, which do not have these safeguards, unless considerations of statutory interpretation require it.[95]

The argument raised against this position is that the legislative history of section 130A[96] will not permit such a view. This is based on *Senate Report* 2375 which states:

> Options which do not qualify as "restricted stock options" will continue to be taxed as under existing law.[97]

It is argued that this means the statutory amendment shall have no effect on non-statutory options. This position does not seem so persuasive as to close the argument.

In the first place, the sentence quoted above must be read in context. The entire paragraph states:

> Under your committee's bill no tax will be imposed at the time of exercise of a "restricted stock option" or at the time the option is granted and the gain realized by the sale of the stock acquired through the exercise of the option will be taxed as a long-term capital gain. Such treatment is limited to the "restricted stock option" for the purpose of excluding cases where the option is not a true incentive device. Options which do not qualify as "restricted stock options" will continue to be taxed as under existing law.[98]

It seems likely that Congress thought all options would be taxed at ordinary rates after the release of T.D. 5507, and that the passage of section 130A marked an area carved out for capital gain treatment. This was a tenable assumption, since no cases under T.D. 5507 had

92. INT. REV. CODE OF 1939, § 130(A), added by 64 Stat. 942 (1950).
93. Lentz, *Stock Ownership Plans—Options, Warrants, Leverage Stock*, N.Y.U. 13TH INST. ON FED. TAX. 499, 513 (1955).
94. S. REP. No. 2375, 81st Cong., 2d Sess. 60 (1950).
95. Note, 62 YALE L. J. 832, 840 (1953).
96. INT. REV. CODE OF 1939, § 130(A), added by 64 Stat. 942 (1950).
97. S. REP. No. 2375, 81st Cong., 2d Sess. 60 (1950).
98. *Ibid.*

arisen prior to 1950. Congress listed all the options which would be considered incentive devices, and which would therefore receive preferential treatment. If this was the assumption, it tends to defeat Congressional policy when non-statutory options are also given preferential treatment.

Secondly, the hearings and debate on the bill also indicate that the provision was written because all stock options were to be taxed as ordinary income. Senator George, introducing the provision on the floor of the Senate, said that the special treatment was intended to be "restricted to true employee incentive options."[99]

The testimony before the House Ways and Means Committee of the 80th Congress, which considered a similar provision, also emphasized the need for preferential treatment because none was available at that time.[100] It seems that the push was to provide for *a* method of preferential relief, not an *additional* method.

It is not asserted that the two arguments above are conclusive. On the other hand, they indicate that the legislative history does not conclusively show that pre-emption was not intended. Where the legislative history is not clear, the strong policy considerations involved should lead to the view that Congress intended to cover the field of preferential treatment when it passed section 130A.[101]

If it is held that the area of preferential treatment has been pre-empted by the specific statutory provision, then the inequities which still exist in the field of non-statutory options would be eliminated. For example, the dictum in *Commissioner v. LoBue* to the effect that some options might be taxable as ordinary income only to the extent of the spread at grant, would not be followed.[102] Similarly, preferential treatment would be denied in situations where restrictions still apply at the time of exercise, as in *Commissioner v. MacDonald*.[103]

(b) Whether or not the pre-emption argument prevails, some of the inequities can be removed.

For example, where the option was freely transferable and had an ascertainable fair market value at the time of grant, it was taxed as ordinary income only to the extent of the spread at the time the option was granted in *McNamara v. Commissioner*. The basis of the decision was the "intention" of the parties to give compensation only to that

99. 96 CONG. REC. 13276 (1950).
100. "The usefulness of stock options as a means of securing and retaining executive personnel [has] been nullified by court decision and Treasury rulings . . . ." Recommendation of the National Association of Manufacturers, *Hearings on Revenue Revisions, House Ways and Means Committee*, 80th Cong., 1st Sess. at 1473-74 (1947). And see the memorandum filed by the Chamber of Commerce of the United States, *id.* at 1599.
101. INT. REV. CODE OF 1939, § 130(A), added by 64 Stat. 942 (1950).
102. See discussion in text of the case of *James S. Ogsbury* at p. 488 *supra*.
103. See discussion in text accompanying notes 53-63 *supra*.

extent. It has been suggested above that this is an irrelevant criterion. The solution appears simple—reject this idea, and tax at the time of exercise.

Another inequity exists where restrictions at the time of exercise prevent valuation. It does not make good sense to allow the complete avoidance of a tax at ordinary rates merely because restrictions complicate the problem of valuation. One approach is to ignore the restrictions and tax on the full value as if unrestricted.[104] This position is supported by the argument that restrictions are nearly always methods of tax avoidance, and that corporations have other devices for insuring incentive and the retention of employees if a non-tax motive is actually present.[105] This seems to be a somewhat harsh result, but may be desirable if the courts will not face the difficult valuation problems which restrictions present.

There are several possibilities for taking restrictions into consideration.[106] Under current treasury regulations,[107] gain is realized when the restrictions lapse, and the amount taxed is the spread at that time. This may be hard on the taxpayer in a rising market; but if it is assumed that restrictions are primarily tax devices, the inequity diminishes. Of the several methods suggested, this one seems to produce the soundest result.

104. Note, 62 YALE L. J. 832, 843 (1953); *contra*, 51 NW. U. L. REV. 621, 627-28 (1956).

105. Note, 62 YALE L.J. 832, 843-44 (1953); *contra*, Koerber & McDermott, *Employee Stock Purchase Plans*, 46 ILL. B. J. 208, 225 (1957).

106. A case comment at 51 NW. U. L. REV. 621, 624 (1956) suggests three: (1) tax at exercise, allowing for restrictions; (2) tax at ordinary rates upon lapse of the restrictions; (3) tax resale of stock as part income and part capital gain.

107. Treas. Reg. 1.421-6 (1959), adopted by T.D. 6416 on Sept. 24, 1959.

VANDERBILT UNIVERSITY SCHOOL OF LAW,
Nashville, Tenn., July 19, 1961.

Re S. 1625, to terminate special tax treatment of employee restricted stock options.

Hon. ALBERT GORE,
U.S. Senate, Washington, D.C.

DEAR SENATOR GORE: This will acknowledge the receipt of your telegram of July 18, 1961, inviting me to testify before the Senate Finance Committee in regard to the above bill which would limit the favorable tax treatment accorded to restricted employee stock options to those issued before April 14, 1961. I will not be able to appear personally on July 20 or 21 before the committee because of other commitments, but I am setting forth my views here for whatever assistance they may be to the committee.

I am in favor of the bill and recommend its enactment. In support of this conclusion the following points and propositions are respectfully submitted:

1. An employee stock option which does not qualify as a restricted stock option under Internal Revenue Code, section 421, is taxed as ordinary income to the extent of the spread between the option price and the market value on the date of exercise, which is the time when there occurs an investment of risk capital in after-tax dollars. Any gain realized subsequent to the investment made upon exercise is taxed as capital gain. The crux of the restricted stock option defined by section 421 is that it does not tax the compensatory element—i.e., the spread between the option price and the market value—at ordinary rates as other compensation income, but instead applies capital gain treatment the same as if it represented risk capital made in after-tax dollars.

2. Stock options are, in fact, compensation income for the favored employee, on a purely discriminatory basis. To the extent of the spread between option price and market value they ought to be taxed as other compensation income at ordinary rates. This will not prevent the participation in future growth by the employee after he has put up risk capital consisting of after-tax dollars.

(*a*) A bonus to a corporate employee paid in stock would be taxed as ordinary compensation income to the extent of its value even though motivated by a desire that the employee share in a proprietary interest.

3. It is fundamental that the favorable capital gains concept should be limited to situations which represent an investment of risk capital consisting of after-tax dollars. To make it a tool for unregulated discrimination in the compensation of corporate employees is obviously an unfair tax treatment.

4. While corporate executives should be appropriately compensated, the restricted stock option has become a tool of abuse whereby a select few, in varying amounts determined by the controlling group, can and do substantially dilute the equity of investors, who have taken their risks in after-tax dollars. In addition to the decrease in book value and liquidation value per share, the market value is affected by availability of more shares. On the other hand, market fluctuations on the upside frequently result when corporate management proposes an amendment to the restricted stock option plan. Thus restricted stock opion plans and amendments to them can and do result in rather sharp and extensive fluctuations in the market price, often times undermining the reasonable expectations of equity investors.

5. The corporate employee who has a genuine incentive to work for capital growth will not be dissuaded by the difference between the 25-percent capital gain rate and his top bracket on only that portion of the growth reflecting the spread between his option price and the market price when he exercises the option. If he has a genuine incentive for growth, he will be going for increase in value after he makes his investment, and he will be entitled to capital gains treatment on this growth, as will all investors.

6. The restricted stock option defined by section 421 and its offspring—the variable price formula, the new stock option plan conceived in an economic downswing, and the "shadow stock" option plan—are contrary to basic fiscal policies of the United States, unfair to other taxpayers who return compensation income at ordinary rates, and a tool of abuse to equity investors. Further, it is believed that the restricted stock option is unnecessary to provide an adequate incentive to corporate employees who receive such options.

Very truly yours,

HERMAN L. TRAUTMAN,
Professor of Law.

The CHAIRMAN. Senator McCarthy?
Senator MCCARTHY. No questions.
The CHAIRMAN. Thank you very much, Mr. Gilbert.
The next witness is Mr. James B. Carey of the AFL-CIO.
Will you take a seat, Mr. Carey, and proceed?

STATEMENT OF JAMES B. CAREY, SECRETARY-TREASURER, INDUSTRIAL UNION DEPARTMENT, AFL-CIO, AND PRESIDENT, INTERNATIONAL UNION OF ELECTRICAL, RADIO, AND MACHINE WORKERS, AFL-CIO

Mr. CAREY. Mr. Chairman and members of the committee, I am James B. Carey, vice president, executive committee of the AFL-CIO; president of the International Union of Electrical, Radio, and Machine Workers, AFL-CIO, which has representation rights of approximately 425,000 workers in the electrical manufacturing industry; and, also, I am the secretary-treasurer of the industrial union department, which is made up of over 60 AFL-CIO international unions that comprise well over 6 million members.

I appreciate this opportunity to appear before this committee to urge support for Senate Resolution 1625.

Let me say bluntly and at the very outset that we are wholeheartedly in support of Senator Gore's proposal, embodied in S. 1625, designed to eliminate the preferential and discriminatory tax treatment enjoyed by corporation executives through the device of stock options.

We are totally in accord with Senator Gore's proposal, embodied in S. 1625, designed to eliminate the preferential and discriminatory tax treatment enjoyed by corporation executives through the device of stock options.

We are totally in accord with Senator Gore's characterization of this device as nothing more or less than a tax "gimmick" "to make millionaires out of corporation managers."

More than that, we fully endorse the Senator's conclusion that stock options provide a small minority of executives with "unconscionable benefits at the expense of stockholders, ordinary employees, and the taxpaying public."

The stock option "racket," and I use the word advisedly, represents, as the Senator has said, "a favoritism in our tax law, a favoritism for the benefit of those who * * * need it least."

But the Senator's language, befitting the dignity of the U.S. Senate, is—in our opinion—restrained. The tax law containing the loopholes that make restricted stock options possible represents more than favoritism; it represents flagrant class legislation designed to enrich corporate bureaucrats and victimize industrial workers and taxpayers.

There is ample reason to believe that the seduction of stock options had more than a little to do with the gigantic criminal antitrust conspiracy—largest in our Nation's history—organized in the electrical manufacturing industry.

That conspiracy swindled the Government and American taxpayers out of billions of dollars in overcharges by means of price fixing and bid rigging.

Moreover, I am firmly convinced that the stock option racket has played a vicious role in collective bargaining negotiations for wage and other economic gains. Industrial executives, I have reason to believe, have refused to consider needed wage increases for their workers—sometimes refusing any increase at all—because they figured that the greater the extent of corporate profiteering the greater would be their stock option opportunities. The logic is clear enough, though gluttonous.

And, needless to say, the more an executive profits on one stock option, the better position he is in to pick up additional options. The opportunities here for round after round of personal enrichment are obvious. Senator Gore has pointed out that many companies are now starting their second and third round of options and he has added:

> There is apparently no end to the greed of corporate executives * * *. These highly compensated executives are not satisfied with what they have. They want ever more and more and at a reduced tax rate. The restricted stock option fits in beautifully.

I am sure such logic and such enticements motivate the executives of a great many corporations, which have permitted the wholesale exploitation of this tax loophole to the extent that the Federal Government alone is losing an estimated $100 million a year in revenue.

This Robin-Hood-in-reverse role, stealing from the poor and giving to the rich—in this case, to top professional managers—not only places additional tax burdens on low-income workers. It also has the tendency, as I have said, to inspire management in collective bargaining to positions of unyielding obstinacy in which they often refuse to consider wholly justified and necessary wage increases for their employees.

Stock options today are the most important aspect of the hypocritical and immoral double standard that industrial management applies to itself and to the workers who produce the Nation's corporate wealth.

What is good enough for top management—stock options, bonus payments, merit salary increases, nearly unlimited expense accounts and such "fringes" as country club memberships—these most certainly are too good for anyone except the aristocracy of management. That is the philosophy today of the new elite, the minority of special privilege in industry.

The proposed legislation is designed to correct a discriminatory tax loophole which makes stock options immensely lucrative. But this legislation by no means eradicates the evil and the bill's author, Senator Gore, recognized this when he said on the Senate floor on April 14, "In my view, the restricted stock option, in its entirety, is without merit and ought to be abolished."

We agree, and that should be a long-range goal. However, the public welfare and the health of our economy will be served now, and served exceedingly well, by enactment of S. 1625.

This bill, as we understand it, provides that any options granted after April 14, 1961, will be treated for tax purposes just as they were before the 1950 amendment to the tax law. The executive exercising an option would be required to report, as ordinary income, the difference between the option price and the market price on the day he picks up his option.

There is nothing complicated in this. It is clear and equitable. It should appeal to anyone's sense of fairness.

The proposal should, for example, appeal to those industrial and business tycoons who are forever lecturing the country on the special and almost divinely endowed insight which permits them to perceive that the Nation is at the crossroads, that our way of life is menaced, that we should all tighten our belts, and all be prepared to make sacrifices.

S. 1625 will enable these tycoons to answer their own clairion calls, will provide them a splendid opportunity to offer an example to the Nation in belt tightening and sacrifice making.

Whether big business and industry believe their own sermons may or may not be questionable; in any event, if the defense of democracy in this critical period requires belt tightening and sacrifices—and organized labor believes it does—then an early, positive step should be the elimination of special-privilege legislation. We should abolish legal loopholes that favor the concentrated accumulation of wealth, encourage the overnight creation of millionaires, and deprive the Federal Government of revenues that probably exceed $100 million a year.

In our opinion, section 421 of the Internal Revenue Code which permitted the stock option evil to grow into monstrous proportions is one of the most discriminatory devices in the history of the Nation's tax system. It is so discriminatory it might easly undermine the faith of working men and women in democracy and representative government.

Morally and economically it is wrong to permit $100,000-, $200,000- and $300,000-a-year executives to enjoy tax favors and preferential treatment that ordinary citizens cannot enjoy.

The well-known 1945 U.S. Supreme Court decision held that when a stock option was exercised, the beneficiary was required to pay full and normal taxes on the difference between the option price and the value of the stock when the option was picked up. But the 1950 amendment to the Internal Revenue Code completely undermined that sensible decision. The amendment specified that stock options granted after February 26, 1945, could qualify as capital gains and would not be taxed at the time the option is exercised but only when the stock is disposed of.

Senator GORE. May I point out one other provision of the 1950 amendment:

That is, when disposed of, whenever disposed of, it will be treated as a long-term capital gain; but there is also the very attractive alternative of no disposition, which would result in no income taxes at all of any kind.

Mr. CAREY. That is correct, Senator. I deal with that later in my remarks.

Senator GORE. I am sorry.

Mr. CAREY. It's quite a different story for the ordinary citizen, the average worker. When he receives compensation or income of any kind, he is expected to pay his regular and nonpreferential taxes. The Internal Revenue Code allows him no options, stock or otherwise.

But let's consider the tycoon who has been handed an option to pick up a block of shares at $23 a share, even though the current market price happens to be anywhere from $60 to $80 a share. When he decides to take possession of these shares and lock them up in his safe

deposit box, he doesn't pay a penny of income tax. In fact, he never will pay a penny of income tax if he decides not to sell but to pass the shares on to his heirs.

If our tycoon—after buying at $23 what was worth $80—decides to hold the stock for 6 months and then sell it, he then pays only a capital gains tax with a ceiling of 25 percent.

The 1950 amendment sent the stock option racket raging across the business and industrial scene like a prairie fire—or, if you wish, like a plague. Stock options soon created a new crop of millionaires, opportunists who have racked up fortunes without any risk whatever.

Senator GORE. I take it you do not object to the opportunity of Americans to become millionaires, or multimillionaires, but you think they should pay their proportionate or fair taxes on the income en route thereto?

Mr. CAREY. Yes, sir.

This get-rich-quick gimmick, in turn, has created in many executives a deplorably irresponsible attitude toward their jobs, an attitude that focuses the executive's attention and concern not on any social or economic responsibilities, but, instead, on the obsessive question of the lowest price at which he can obtain stock options from his company and at which profiteering price can he dump the stock back on the market.

Under such pressures the executive becomes less and less concerned with human values and more and more concerned with option values. He becomes less and less conscious of the company's employees and their needs and more and more conscious of the money-grubbing potentials in the 1950 amendment to the Internal Revenue Code.

Consequently, he is decreasingly interested in smooth and effective collective bargaining. On the other hand, he may well become a great deal more interested in starting or participating in price-fixing conspiracies, on the presumption that the enormous profits mushrooming out of the flagrant overcharges will make possible bigger and better stock options.

But stock options are not only wrong from the standpoint of the Government and the standpoint of production workers, both of whom are grossly swindled. They are wrong, also, from the standpoint of the stockholders.

Although economists and members of this committee have exploded virtually all the myths and fictions that industry has dreamed up to justify the stock option racket, still the myths and fictions are peddled to stockholders' meetings each year with all the solemn pretentiousness of a divine revelation from the "Mount Olympus" of capitalism.

Let me cite the 1961 stockholders' meeting of General Electric as an example. I select this meeting because I was there in Syracuse on April 26, and had to sit hour after hour on an uncomfortable seat while General Electric management tried to lull us to sleep with the same old decrepit fairy tales that they have regaled stockholders with year after year.

Stock options, GE tried to convince us, are the ultimate in corporate wisdom because, allegedly, they accomplish three splendid purposes:

1. They enable the company to meet the vigorous competition for competent executives.

Senator McCarthy. If the witness would yield, this seems to me to pose the same problem that the major leagues are now facing with regard to bonus players; does it not?

They have acknowledged that this is a losing game, and they are trying to do something about it. But the great corporate directors of the country seem to think that this kind of competition is a good thing.

Mr. Carey. Yes, it is a form of unfair competition. But then the big leagues of baseball, they are pikers compared to what they do with companies that I deal with in the electrical manufacturing industry.

Senator McCarthy. They acknowledge that this is a losing game from the standpoint of competition, do they not?

Mr. Carey. Correct.

2. Says GE, stock options spur key employees on to keener efforts on behalf of the company.

3. They give these individuals a chance to share in the company's resulting success.

Let us scrutinize these claims briefly.

First, there's the claim that stock options permit the company to meet the vigorous competition for competent executives.

If stock options are sanctioned by the tax law and if they have widespread popularity in industry, then, of course, the individual company may find it necessary to provide a stock option plan to meet competition.

However, if the preferential tax treatment—which is the great appeal of these plans—was ended, then all companies would be on an equal footing. They would then recruit executives on the basis of salaries, fringe benefits, promotion opportunities, prestige, and future potentials. No company would have an advantage over another, in tax terms, and the American public and the U.S. Treasury would be the beneficiaries.

End of myth No. 1.

Second, says GE, stock options spur employees on to keener efforts on behalf of the company.

This is an astonishing argument to come from a company as large and as affluent as GE. Their executives not only receive huge salaries, but profit-sharing allowances, lavish retirement benefits, and various other bonuses as well. We can only guess at what they can bury in their expense accounts.

Senator Gore. In connection with spurring to keener efforts, I wonder if that has some connection with price fixing.

Mr. Carey. It has, and that is what I testified, I mentioned it, and I want to support that statement that I made.

But despite all these varied and rich emoluments, we are asked to believe that GE executives would not give their best efforts to the company without the stock option racket. Only these options, we are told, can inspire the well-heeled GE bureaucrats on to keener efforts.

What would Chairman Cordiner of General Electric do without his stock options? What would President Cresap of Westinghouse do; and Chairman Donner and President Gordon of General Motors? What would they do: sulk in their offices? Sabotage the company by slow-down strikes, or by taking unneeded sick leave?

What a commentary it is on the integrity of American industrial executives if the stock option racket is indispensable to their keener efforts. What's happened to the vaunted idealism of our industrialists and big businessmen? What's happened to their boasted economic and social conscience? What's happened to their heroic posturing over "people's capitalism" and progress being "our most important product"? According to GE's argument, big business and industry executives, no matter how extravagantly they are paid, won't do their best for their companies nor for the American economy unless they are offered the additional seductions of "buying poor and selling rich." If that isn't close to moral bankruptcy, I don't know what can be.

Chairman Cordiner last year drew down a respectable $280,000 in salary and in cash profit-sharing. But, in addition, Cordiner claimed 1,331 shares of GE stock as additional profit-sharing worth about $85,000 at present prices. Thus, Cordiner—aside from stock options—was handed $365,000 last year. For Chairman Donner it was $570,000; and for President Gordon, $530,000.

According to Senator Kefauver, if Cordiner had "sold stock which he had purchased under stock options as of April, 1959, he would have netted approximately $2 million after payment of capital gains taxes."

This was Cordiner's incentive to keener efforts but apparently it did not provide sufficient incentive for him to discover his company's leadership in the biggest criminal antitrust conspiracy in American history.

But other men in other walks of life don't have to be enticed with ever-larger amounts of lucre into putting forth their best efforts. Most members of the U.S. Senate, I dare say, get along on their $22,500 a year and don't need stock options in order to give the American people their best service. Doctors and social service workers, clergymen, members of the Armed Forces, farmers, and civil servants, writers, newsmen, and even trade union officials—these don't seem to need stock options to insure their maximum devotion and most effective labors.

End of myth No. 2.

Third, GE argues that stock options give these individuals a chance to share in the company's resulting success.

This argument falls apart when it is known that a large part of the incomes of GE executives comes from profit-sharing, a system which gives the executives a major incentive to promote the company's success and growth.

Last year, for example, GE's board of directors allotted no less than $15,500,000 for incentive compensation. In General Motors the amount was $90 million.

Clearly, GE and other executives can, and do, share in their company's success without getting discriminatory tax benefits.

End of myth No. 3.

Sometimes the point is advanced that corporation executives, despite stock options, find themselves in higher tax brackets that take away large amounts of their incomes.

However, many corporation executives have been able to slash their tax levels by such devices as establishment of foundations, and

division of their income among children. No such devices are available to the mass of American wage earners as methods of circumventing the payment of their full tax obligation (assuming they would seek such a circumvention, which I deny).

No circumstances, however, justify discriminatory treatment in favor of higher bracket incomes. If the tax structure is unjust, then it can be adjusted by Congress. But the basic and fundamental truth is this: All men should be equal before the tax collector exactly in the way that they are considered equal before the law.

There is still further evidence that stock options swindle stockholders.

When a company issues stock priced at only a fraction of the current market value, that action inevitably dilutes the value of the stock held by current stockholders. Thus, if a company's stock carries a current market value of $60 a share and if executives are able to arrange for their own purchase of stock at $23 a share, the value of the stock must necessarily suffer and might even decline.

Stock option schemes are essentially unnecessary. Should a board of directors or a stockholders' meeting conclude that key executives are insufficiently compensated, they can provide necessary salary adjustments or other benefits which will then become business expenses which can be deducted from the corporation's income. In turn, the executives will pay taxes, as do other citizens, on the additional income. This, obviously, is the forthright and honest way to handle problems of executive compensation.

The capital gains provisions of our tax laws were written on the assumption that an investor takes a risk in making a capital investment and, therefore, was entitled to special treatment if he made a gain on his investment.

Even if the assumption were valid, this theory should have no application whatever to the stock option racket. There simply is no risk involved in the overwhelming majority of stock option schemes. Most option plans, for example, permit an executive 10 years in which to pick up the option.

Therefore, unless the company falls on incredibly hard days or tumbles into bankruptcy, the current market price will inevitably be much higher than the option price. Even if the stock should decline, little or no risk is involved because of the large margin usually set between option price and current market price.

As one GE stockholder expressed it:

> A stock option is like betting on a horserace when the race is over.

Moreover, let it be remembered that capital gains provisions were written into the tax laws presumably for citizens who intend to make a capital investment. But in the option racket, the clear-cut fact is that until the option is picked up, there is absolutely no investment made, and even when the option is exercised, the executive often is able to borrow the money from a bank or from his own corporation.

Another fond theory advanced to justify stock options is that possession of the stock and the prospect of increasing profits give an executive a permanent stake in the company and assure the company of the executive's continuing services and devotion.

Greed, however, seems to have demolished this theory. In a very large number of cases—an increasing number of cases, I believe—executives have picked up their stock options, held them for 6 months, and then sold them for tremendous profits. In turn, these profits are used to pick up more options which are also sold, reaping another whirlwind of profits.

The whole business thus becomes a gigantic stock market manipulation contrived and engineered without risk to the executive.

Stock option programs can, in fact, even result in the reduction of holdings by a company's officers. Such has been the case, for example, at Texas Instrument in Dallas. Here adoption of the stock option plan was followed by a marked reduction of shares held by the firm's chief officers. In view of this, it would be concluded that the stock option program weakened instead of strengthened the ties between executive and company.

There is still another device by which a business executive insures himself against loss—in fact, insures himself actually for a profit—in the operation of stock option plans.

This is an arrangement with a Wall Street broker called a "put." The executive decides on a price for which he will sell his stock. For a fee he arranges with a broker to dispose of the stock the moment its price reaches the specified level.

For example, earlier this week the New York Times reported that for a fee of $475 for 100 shares, a "put" on Jones & Laughlin Steel could be exercised at a price of $64.75 a share until January 9, 1962. If by January 9 the executive does not wish to sell his stock, he can arrange for another "put." And a recent U.S. Treasury ruling held that such a "put" does not constitute disposition of the stock.

The democratic procedures—or, more accurately, the lack of them—by which stock options are decided upon can make a fascinating study in themselves. The common superstition is that option plans are devised by a committee of the board of directors and then approved by stockholders.

Frequently, that is blatant nonsense. Often the top executives, a few of whom may also serve on the board of directors, decide that they would like a stock option plan or would like to enlarge the one already in existence. They themselves work out all the details in secret. The president will be assigned an option for 10,000 shares, for example; the executive vice president, an option for 8,500 shares; the first vice president, 7,000 shares; the second vice president, 6,000 shares; and so on down the line.

The determinations—who will get how much—are completely arbitrary, even whimsical. They follow no rule or formula, and vary enormously from company to company.

In such cases, where management works out the number and size of the options—the scheme is then presented as a finished product to a committee of the board of directors or directly to the board. It is then adopted by the board, usually without a quibble.

After that the plan is presented to the stockholders' meeting for approval. But usually the matter has been settled by the nodding heads of the directors sitting in a smoke-filled room.

As is well known, at the vast majority of stockholders' meetings the meeting itself is stacked with shareowners who are either friends or

stooges of the management or individuals who have already given their proxies to the administration. In any event, the number of votes represented by stockholders actually present at meetings is ridiculously tiny compared with the number of votes that management has in its pocket in the form of proxies. In the April 1961 GE stockholders' meeting, for example, all votes on controversial issues resulted in totals of approximately 69,800,000 to 1,400,000 in favor of management; a ratio of 69 to 1. The great bulk of management's 69,800,000 votes was, of course, in proxy form.

The amount of democracy in such an operation speaks for itself.

Because I and other officials and leaders of the IUE–AFL–CIO attend stockholders' meetings of companies in our industry, we know that there isn't a semblance of democracy in most stockholders' meetings and not a semblance of democracy in the overall operation of most corporations. For that reason we concur completely with this statement by Senator Gore:

> The corporation today is of paramount importance to our economic existence and yet in many instances it has gotten completely out of the hands of its owners, and is under the control of a small group of managers who are not effectively accountable to anyone.
>
> Who actually controls the corporation, and who, in turn, is served by the corporation? These are serious questions involving the national interest. Willful men, in their reckless scramble for personal power and fortune, prestige, and pecuniary benefits, are using our great corporations for their own advantage, forsaking the national good, the general public, and even the actual owners of the corporation, its stockholders.
>
> One wonders if the large amounts of stock options held by General Electric and Westinghouse executives might have motivated some of them to act in a more extraordinary way in entering into collusive agreements to fix prices, thus violating the law of the land and doing as yet unmeasured damage to their customers.

"One wonders" indeed, to use Senator Gore's words, about the correlation between the operations of the stock option swindle and the antitrust swindle of the Government and the public by billion-dollar electrical manufacturers.

I might say, Senator, interposing at this point, that our Union has undertaken to take this whole matter of the price fixing that we believe is seeded and cultivated through these stock option programs and put them into a book entitled "The Public Plunder." And I brought with me copies for the members of the committee and anyone else interested.

Using their inside information, GE executives last year sold at least 40,000 shares at prices $20 to $30 higher than the present market price.

I point up, Senator, in the last few years, even though Mr. Cordiner under the stock-option racket can buy shares at $23.25, these shares of General Electric attained a market value of $99.80.

And now it is down to, hovering in the area of $63 or $64. And under the program that GE tried to foist upon the employees, they were required to buy the stock by yielding contracted wage increases for this stock at the market value.

Many of the employees purchased the stock at the discretion of the company for $80 and $90 and $99. And today the stock is $63.

It is an unfortunate proposition. But, of course, Mr. Cordiner could not lose, because he can purchase stock at $23.75, some at $24, and sell it to their own employees at the market value, and then be-

cause the stock is dumped on the market, it does impair the value of the stock, and it goes down.

I own 100 shares of General Electric stock that I purchased for my daughter. I purchased it at $68. A loss had been sustained on that. Our union owns stocks in practically all the companies we deal with, to provide us the opportunity of getting the financial reports of the company and appearing before stockholders' meetings.

And we regret that corporation executives can buy stock at $23.75, and at their discretion, within 10 years, not only get the advantage of the price proposition, but also they can get forgiveness of any taxes based on the income derived from that.

This program provided executives and insiders with a market for their sales in 1959 and 1960. We branded that program a hoax at the time and we find reason more than ever today for repeating the charge with GE stock hovering around 62.

A study, or better yet a congressional investigation, might well be made along the lines suggested by Senator Gore's speculation about the motivations of GE and Westinghouse executives in stock option operations and in price-fixing operations.

One thing we do know already. Many of the executives who pleaded guilty or no defense, many of the executives who were fined or sentenced to jail in the huge criminal antitrust case, were nearly as busy in recent years fixing their stock options as they were fixing prices.

They brought the same standards of morality to the internal operations of their own companies that they did to their relations with the Federal Government and even the national defense program.

Greed triggered the vast antitrust conspiracy and greed is responsible for the scores of millions of dollars which the Government is losing through the stock option racket.

Let no one drag out that feeble platitude that morality cannot be legislated. In the case of corporations it has been legislated a hundred times since the days of the robber barons and still is being effectively legislated. There will be fewer price fixers now that seven top GE and Westinghouse executives have spent time behind bars. There will be even fewer price fixers in the future if, as some Members of Congress have proposed, the Sherman antitrust law penalties are made even stiffer.

Congress can remove a large part of the incentive for corporate greed—and thus corporate crime—by abolishing the tax loopholes that make stock options the profiteering racket they now are. Congress can do it by enacting S. 1625.

We of the AFL–CIO Industrial Union Department and of the IUE–AFL–CIO strongly and respectfully urge this committee to give the proposed legislation the approval it highly deserves.

The CHAIRMAN. Thank you, Mr. Carey.

Any questions?

Senator GORE. I notice, Mr. Carey, you have appended to your statement some examples. I take it you would like those printed in the record.

Mr. CAREY. Yes, sir; we respectfully request that the examples that we cite, which are factual examples of corporations that we have had experience with, be incorporated in the record.

And I might at this time, sir, subscribe to the views presented by Mr. Gilbert at this hearing. It is seldom as a labor leader I have an opportunity to be in such distinguished company as the members of this committee, and at the same time to be in such distinguished company as the representative of the shareholders as represented by Mr. Gilbert.

Here labor has a common purpose with the U.S. Government and with Members of Congress and with the shareowners in seeking relief from this terribly demoralizing, immoral conduct in the form of this stock option racket and tax evasion.

As to the suggestion made by the Department of the Treasury representative, I must say that 10 years experience with this racket, in seeing the losses that are sustained by the U.S. Government is a long enough time to study the evils of this tax loophole.

And we ask through the enactment of the legislation you propose, Senator Gore, that we get back to the wisdom that was exercised by Congress and by the Supreme Court in 1950, that income derived should be taxable even if it is derived on the basis of a stock option program.

And as to the suggestions of restricted stock option programs being different from the normal stock options programs, it has been our experience that this racket is restricted to the high executives of corporations.

It is unfortunate that we mix up our philosophy about taxing as capital gains these get-rich-quick gimmicks, because the practices over a period of 10 years have been getting worse and expanding further and further.

The stock of one corporation—it happened just yesterday in one company, and happened in several other before that—and this, sir, is price fixing at its worst—the price of the stock was fixed so that if the market valve goes down for that particular stock then they merely vote to reduce the option price. It is unfortunate that something like this could persist for 10 long years, and only recently through your courage, Senator, was the matter called to the attention of the Congress and the public.

We have been pointing this out for the last 10 years. We pointed it out in opposition when this change was made in the Internal Revenue Code.

I am pleased that I have this opportunity today to point out the fact, as Mr. Gilbert did, that our worst fears were well founded as we expressed them on behalf of organized labor over 10 years ago when this matter was then under consideration.

The CHAIRMAN. Without objection, the appendix will be inserted in the record.

(The appendix referred to is as follows:)

APPENDIX

THE STOCK OPTION SWINDLE IN OPERATION

Restricted stock options, as we have demonstrated, swindle the stockholders, swindle the employees, and swindle the Government by depriving it of enormous tax revenues it otherwise would have.

The proliferation of stock option schemes throughout American industry and some of the unfortunate consequences of their operation are shown in the following examples of major industrial firms.

FORD MOTOR CO.

Ernest Breech, former chairman of Ford Motor Co., in 1953 obtained an option for 90,000 shares at $21 a share. He bought the shares for a total price of $1,890,000. At today's market they are worth $7,650,000—returning a profit of $5,800,000 on an investment of $1,890,000.

Three other Ford executives got options for 75,000 shares each and each has a profit of $4,800,000. Five executives, including former personnel director John Bugas, and the company's chief economist, Theodore Yntema, got options for 60,000 shares with a current profit protection of $3,800,000.

These nine individuals can make a profit of $41 million on this risk-free deal.

Yet the industry's employees are warned not to ask for improvements in job security on grounds that they might create inflation.

ALUMINUM CO. OF AMERICA

In 1956 Alcoa granted options for 198,000 shares at $117.25. Sometime thereafter the price of the stock began to decline. It hit a low of 76 in 1957 and then continued to decline in 1958. On March 7, 1958, the company decided that executives should not have to wait like ordinary stockholders for stock prices to recuperate. Alcoa exchanged old options to purchase shares at $117.25 for options to purchase shares at $68.50.

The nationally known financial editor of the Philadelphia Bulletin, J. A. Livingston, wrote:

"Stockholders of the Aluminum Co. of America, who suffered the humiliation of watching their stock drop from more than $120 a share to less than $70 in the last 2 years, may have read with mixed emotions the decisions of the corporation's top executives to spare themselves and some 300 other officers and employees a similar indignity. A fairy godmother stock option committee, consisting of the six highest paid directors and officers, voted to cancel options on 198,000 shares of Alcoa stock at $117.25 and to reissue options share for share at $68.50."

When another large company, Olin Mathieson, exhibited a similar tenderness toward its executives, one of its stockholders wrote:

"I believe (this) takes the cake. I wonder what Olin's board of directors would say if I asked them to remit the difference between what I paid and what it's worth now." (Lewis D. and John J. Gilbert, 19th Annual Report of Stockholders Activities at Corporation Meetings During 1958, p. 141.)

UNITED STATES STEEL

Chairman Rodger Blough, of United States Steel, is fond of lecturing hundreds of thousands of employees on the dangers of inflation and on the necessity of tightening our belts.

In the period 1951–56, Blough received options for 12,000 shares at $20.50 a share, 16,000 at $18.50, and 12,000 at $48. (These were adjusted for the two-for-one split in 1955.) In the period 1954–56, he exercised his option for the first 28,000 shares paying $542,000. The additional 12,000 shares will cost him $576,000, or a total of $1,118,000. The 40,000 shares are now worth $3,200,000 which can present Blough with a profit of $2,100,000.

TEXAS INSTRUMENT

The company's amended stock option plan adopted April 20, 1960 specified that a total of 350,000 shares would be made available to officials out of a total of 3,000,000 shares outstanding. This is equal to nearly 9 percent of the total outstanding shares. Options for 150,000 shares were granted from 1957 to 1959. Of these, 78,500 shares were priced at $28.50, 16,500 at $37.75, and 17,000 at $69.12. When it is recalled that Texas Instrument stock recently soared as high as $200 a share and it is now about $140, the spread between the option price and the market price is staggering. The following financial moves of the chief officers on this matter are extremely interesting.

S. F. T. Agnich, vice president and a director: He has an option to purchase 6,000 shares at an average price of $46 a share. He did not exercise any of his options but nevertheless sold 6,600 shares in the last few years at an average price of $120 a share. When he picks up his options he can count on a profit of about $500,000. Since 1957 when the stock option plan was introduced, he has reduced his holdings of TI stock from 29,900 to 28,400.

W. D. Courtsey, assistant vice president, personnel: In 1958 he purchased 2,000 shares at $28.50 a share. In 1950–60 he sold 1,925 shares giving him a profit of $321,000 with the remaining 75 shares worth another $10,000. Thus his total profit can come to $330,000. Courtsey reduced his total holdings from 5,200 shares in 1957 to 5,100 today.

Mark Shephard, vice president, semiconductor-components: He has options which he has not exercised for 15,000 shares, of which 10,000 are at prices between $28.50 and $69 a share. Yet he sold 1,000 shares in 1960 for about $200,000. When all his options are exercised his total profit could be above $900,000.

S. T. Harris, vice president, marketing: He purchased 5,000 shares at $28.50 a share and sold 4,800 shares at an average of $195 a share. His total profit on these stock options runs well over $800,000. In spite of th stock options, his holdings of stock increased only 1,500 shares in the last 4 years.

E. O. Vetter, vice president, metals and controls: He purchased 3,000 shares at $28.50 a share and in the last year sold 1,600 shares at an average close to $200 a share. His profit will be well over $400,000.

W. Joyce, vice president, apparatus: One of his purchases was for 5,000 shares at $28.50 a share. He sold 7,500 shares at close to $200 a share. His profit on this stock option transaction is over $800,000. Joyce reduced his holdings of TI stock from 16,000 shares in 1957 to slightly more than 6,000 shares today.

P. E. Haggerty, president and director: In 1957–58 he was granted options which he did not exercise on 20,000 shares at prices between $28.50 and $69.12 a share. Between 1958 and 1960 he sold 13,000 shares for about $1,500,000. He now can make a total profit, at current prices, of about $2,500,000 by picking up his options. Since 1957 he had reduced his TI holdings from 142,000 shares to 118,000.

These records show clearly that the TI officers were not bothered by the regulations of the plan which states: "The plan requires that each grantee represent at the time an option is exercised that he is acquiring the shares solely for his own account for investment purposes only and not with a view to distribution or for resale."

Nor was the plan successful in providing an increased stake in the company. The sharp reductions in the holdings of the officers after the introduction of the plan testifies to this.

It is significant, too, that at the same time the stock option plan was developed the corporation developed for employees a profit-sharing plan and a stock purchase plan both of which involved the purchase of TI stock, thus helping to establish a market for the sales of the executives. This is similar to the experience in General Electric.

GENERAL ELECTRIC

Under the plan adopted in 1953, 3,500,000 shares were alloted for option among executives. The following table shows the allotments:

Name of individual or identity of group	Number of shares purchasable						
	$23¾	$24⅛	$45	$52¼	$68½	$305⅛	$50
Ralph Cordiner	45,000						
Philip Reed	33,000		750				
Robert Paxton	32,250		5,250				
Officers as a group	592,386	11,850	150,406	61,527	1,739	550	6,741
Employees as a group	1,533,840	818,846	620,576	701,227	156,048	32,303	38,783

What is immediately significant is that even among the executives there were class distinctions. For example, Board Chairman Ralph Cordiner got all of his shares at $23.75 a share. Reed, who was then chairman of the board and Paxton, who was the executive vice president, had to pay $45 for some of their shares. If the officers are considered as a group, they obtained only 70 percent of their shares at $23.75 and $24.16. If we consider the executives as a group, they got only 59 percent of their shares at these most favorable prices. One reason for this may be the fact that Cordiner demanded and received the right to review the stock options of other executives even though he was not a member of the stock option committee.

Based on a current price of about $64-a-share, the following are the profits available for the options granted and options already exercised.

	Profits on options exercised	Profits on options granted
Ralph Cordiner	$1,400,000	$1,750,000
Officers as a group	17,800,000	26,600,000
Executives as a group	64,200,000	108,100,000

It will be noted here that the value of the shares is stipulated at $64. However, a considerable number of option shares have been sold by these executives at much higher prices. For example, in 1960, a group of about 20 executives sold nearly 38,000 shares at prices ranging between $80 and $93 a share. Since GE stock is expected to rise again in the coming years, the profits on these options will be, of course, much larger than indicated here.

The following represents stock option purchases and sales by seven key GE officers during the last 2 years alone:

John Belanger, vice president, customer relations industrial group: Between 1957 and 1959 he purchased 10,000 shares on option for an average approximating $35 a share and sold 5,700 for an average of $75 a share. The sales were generally 6 months after purchases. Belanger stands to realize a total profit of $334,000 on these operations.

William Ginn, recently forced to resign as vice president of the GE industrial group because of the antitrust violations: In 1959 he purchased 1,800 shares at an average of $39 a share. Early in 1960 he sold 2,000 shares at an average of $89 a share. His profit on the 1,800 option shares is $90,000.

James Goss, executive vice president: In 1959 he purchased 7,500 shares at an average of $52 a share. In July 1960 he sold 5,500 shares at an average of $86 a share. He already has a profit of $87,000 and has 2,000 shares free of charge. At today's market prices they are worth $128,000 which would give him a total profit of $215,000.

C. K. Rieger, vice president in charge of marketing services: In 1958 and 1959 he purchased 4,400 shares on option at an average price of little more than $28 a share. In 1960 he sold 3,890 shares at an average price of $83 a share. He already has a profit of $215,000 and owns 516 shares free of charge. At today's prices they are worth $33,000 and should realize a total profit of $248,000.

Robert Paxton, recently resigned as president: From 1958 to date he purchased 13,173 shares on option at an average price of $29 a share. In the same period he sold 5,225 shares at an average price of $83.43 a share. He already has a profit of $50,000 and has 8,000 shares free of charge. At present prices they are worth over $508,000, giving Paxton a total profit of over $550,000 for these risk-free maneuvers. Undoubtedly the extra 1,000 shares sold were previously obtained on option in which a substantial profit was realized.

Ralph Cordiner, chairman of the board: Between 1958 and 1960 he purchased 18,000 shares at an average of $23.75 a share. Between 1958 and 1960 he sold 10,565 shares at an average price of nearly $72 a share. He already has a profit of $326,000 and has left 7,500 shares free of charge which at today's prices are worth $480,000. Thus, Cordiner's total profit on these transactions will be over $800,000.

I.T. & T.

The original I.T. & T. stock option plan became effective in 1956 and under the plan employees could be granted options to purchase an aggregate of 300,000 shares, the maximum per person being 20,000.

The plan was modified in 1959 and an additional 200,000 shares were offered for option. In 1961 the plan was again revised and this revision allocated 400,000 shares. Under the revision 50,000 can be purchased by the chief officers and 30,000 by other officers.

Harold Geneen, president: On June 10, 1959, following his election as president, a special option to purchase 30,000 shares was granted him. The option price was $35.875. This was in addition to the maximum allotted option of 20,000 under the original 1959 plan. If Geneen were to exercise his option for 30,000 shares, at $35.875 and sell them at today's price, his profit would be

over $500,000. On the basis of the original 20,000 shares, Geneen can make an additional profit ranging from $200,000 to $500,000.

Edmond Leavey, former president and director: In 1959 he purchased 20,000 shares at $15.68 a share. At today's prices his profit would be $771,000.

Charles Hilles, executive vice president: In 1958 and 1959 he purchased 15,000 shares at $15.68 a share. In 1960 and 1961 he sold 4500 shares. His profit at today's prices would be $570,000.

Fred Farwell, former executive vice president: Farwell purchased 15,000 shares at $17.65 a share. At today's prices his profit would be $549,000.

Senator GORE. I take it you do not think that Secretary Dillon would need a large number of months to develop an opinion on restricted stock options?

Mr. CAREY. From my personal knowledge, Secretary Dillon, because of his experience with the Government before, and with the philosophy he set forth as a believer in sound business programs and sound fiscal policies, Secretary Dillon, I am confident, would testify as I have testified. He has had experience on the other side of the picture in addition to his experience with Government.

I was rather surprised that you, Senator Gore, interpreted the representative of the Treasury Department as wanting to wait until they set forth their comprehensive recommendations.

As I understood the representative's testimony, he said if the Congress wanted to deal with it now, with the exception of those minor criticisms of your bill, it ought to be dealt with now. And it is long overdue, in fact.

Certainly, as you put it so well, you cannot have a fair tax program without the elimination of this particular provision; and with the enactment of your bill that fair program could be brought about.

I fully and completely agree with Mr. Gilbert when he said abolish this injustice now and then proceed to make the studies that are necessary.

I do believe that Secretary Dillon would subscribe to that proposition.

Senator GORE. Well, I hope he will.

I was disappointed that the Treasury was not prepared at the first opportunity to recommend the elimination of this tax gimmick for which I see no merit. Perhaps the Treasury—well, I have not found anyone in the Treasury yet who sees any merit in it. There may be some.

But at least the representative of the Treasury, upon my request, says they will develop a position; that is they will make a recommendation one way or the other.

Mr. CAREY. Senator, perhaps the Secretary of the Treasury is in a somewhat similar position as I am. The fact that these hearings were called is only a matter, to my knowledge, of a few days. It is quite possible that if Secretary Dillon was made aware of the hearing being called on this subject he might have had a better opportunity to prepare.

I understand that Secretary Dillon is engaged in activity that was scheduled in advance of these hearings. I have no authority to speak for Secretary Dillon; I just say that my experience with Secretary Dillon in other capacities when he was a very able Government servant in a different administration would lead me to believe that he would be testifying here today and not leave it to a subordinate of the U.S.

Treasury if he had ample notice that this testimony would be heard at this time.

The CHAIRMAN. The Chair would like the record to show that he offered to postpone the hearings for Senator Gore if he desired to have more time. But Senator Gore desired the hearings to proceed.

So I do not want any blame to lay on the Chair that sufficient time was not given to the hearings.

Mr. CAREY. I am not suggesting that, Mr. Chairman.

The CHAIRMAN. You said the Secretary didn't have time enough to get up his statement.

Mr. CAREY. I am saying the Secretary may have other duties to perform, if he got the same kind of notice I have.

Now, I am not suggesting that there is an excuse for the Secretary, or that that is the responsibility of the Chair. I indicate to you, Senator, my pleasure at being able again to see you. I had time to prepare the testimony on the subject, even though it was the same notice. And I would say this, that I do sincerely believe that Secretary of the Treasury Dillon or any Secretary of the Treasury would take the same position that Mr. Gilbert took, the same position that labor takes through me on this particular subject.

The CHAIRMAN. Any further questions?

Senator GORE. Yes, sir.

You say Secretary Dillon is engaged in other activities. As a result of those activities, of which he, of course, is only a part, representing the executive branch of the Government, this so-called tax reform bill of 1961 is expected to reach this committee sometime late in August. And I was advised yesterday by the distinguished majority leader of the Senate that he hoped the Senate would adjourn by Labor Day. So you see that some interesting things happen with respect to tax legislation.

But the first tax reform bill that goes to the floor of the U.S. Senate in 1961 or 1962 will afford an appropriate opportunity to thoroughly consider the closing of this tax loophole, which I think is as unjustified as any of which I have knowledge.

If this committee and the Senate have only a week in which to consider the important question of tax legislation, it may be necessary to postpone consideration of that bill until January.

In any event, whenever that bill is considered, I will expect the Treasury to submit its recommendations on this point.

And I am assured this morning by the representative of the Treasury that that will be done.

Mr. CAREY. Senator, could I suggest one thing?

In the course of questioning by Senator Curtis, directed to Mr. Gilbert, it was suggested that perhaps if we took plenty of time for further study of this proposition we might be able to design legislation that would keep the present stock option plans in operation and would only abolish them in the future. That is a view that I must vigorously oppose, because if you permit the continuation of this tax-free income, or this preferential treatment of some corporations in American industry, and deny it to others, that, too, would create an inequity.

It has to be, as you propose in your bill, abolish it first, and then proceed from there to an equitable arrangement.

So I endorse Mr. Gilbert's arguments for your proposals rather than the other suggestions that more study time should be allowed.

More and more corporations are adopting stock options, because it is an easy way to make a financial killing at the expense of the Government, at the expense of the stockholders, and at the expense of employees.

Senator GORE. This country, Mr. Carey, despite the imperfections of the system, has developed the greatest and most equitable system of taxation of any country in the world.

Without the progressive income tax, for which a fellow townsman and predecessor of mine led the fight—I refer to the late Cordell Hull—this country simply could not have attained the position in the world which it now enjoys. I am deeply concerned that with the proliferation of gimmicks of favoritism, a notorious example of which is the restricted stock options which gives tax-free income to many people in very large amounts, the Nation's tax system and law may become the subject of derision and contempt by the citizenry of our country.

This would be a mortal mistake for the society.

We must strive for fairness and equity in our tax laws.

This tax treatment of restricted stock options has no earmark, in my opinion, of either fairness or equity. It in no way conforms to ability to pay. It in no way meets the standards which I think must be applied to our taxing system.

Mr. CAREY. Senator Gore, you are absolutely right. I am one that reveres the memory of Senator Hull for this contribution to the Nation's welfare on tax questions. It was one of the first subjects on which I, as a young labor leader, I testified before a congressional committee. It was in 1934, on reciprocal trade agreements, and labor was vigorously in support of his proposals.

In addition to the great men of Tennessee who have been interested in progressive tax proposals are the great men of your State, Senator, Virginia.

We look to you, Senator, for the solution of this problem and also for the plugging of other tax loopholes. I refer to individuals and companies that go abroad and get special tax advantages which guarantee them high profit rates not enjoyed by other Americans. This is not the only other loophole; there are several that bring disrespect to an otherwise good tax structure.

Senator Glass and President Wilson and others made great contributions to this kind of tax system, in addition to Senator Hull.

I want to say thanks for seeing you again as well. It has been many years since we have come together. But the relationship has been long, and despite differences that may arise on other matters, on this one we ought to be of one mind.

I would hope the chairman of the committee will continue to inspire Senator Gore to continue his efforts to get enacted by August the legislation that eliminates this glaring mistake in our tax structure.

Senator GORE. I do not want to participate in the commitment of the chairman of this committee to this point of view. But I do want to take this occasion to thank him for his generosity in calling this hearing, not for 1 day, but for 2.

When the Treasury indicated that it was not prepared at the moment to take a position on the bill, the chairman of this committee very generously suggested that he would postpone the hearing if I so desired until the Treasury was prepared to take a position. I thank him for that, too. In fact, he is generous in many regards.

I thought since other witnesses had asked to testify, since they had arranged their schedules to be here, that we should proceed with the testimony, and I so indicated to the chairman. He went further and said that the Treasury would have an opportunity to appear later on to give its views on this bill.

So insofar as fair and respectful treatment of this subject matter, and of me as a committee member, the conduct of the chairman has been exemplary.

The CHAIRMAN. I appreciate very much the kind words.

Mr. CAREY. It wouldn't do you much damage, would it, Senator?

The CHAIRMAN. Mr. Carey, these are the first friendly words I have had from anyone connected with the CIO for many years.

Mr. CAREY. I hope they are not the last, Senator.

You know, I was a resident of Virginia, and many members of my family are still residents of Virginia. This is an unusual opportunity for us to be in such harmony.

The CHAIRMAN. The Chair hasn't yet stated his position.

Mr. CAREY. Thank you very much, Senator.

The CHAIRMAN. Thank you, Mr. Carey.

The next witness is Mr. Stanley L. Kaufman, of New York.

Will you take a seat, Mr. Kaufman, and proceed?

STATEMENT OF STANLEY L. KAUFMAN, NEW YORK CITY

Mr. KAUFMAN. Senator Byrd and members of the committee, since this morning appears to be occupied by Senator Gore's admirers or claque, I don't want anyone to be confused into thinking I am going to speak in favor of stock options. My point of view is, summing up my prepared statement, that they smell to high heaven, and they have smelled for 10 years to high heaven, and that any suggestion of a need for any further study as to how much they smell or why they smell is thoroughly hypocritical, and would be hypocritical.

I would like, Mr. Chairman, to have my prepared statement printed, and I shall make a few brief remarks.

Senator Gore's last remarks concerning the immorality and inequity of the stock option loophole is really the primary issue.

I think that stock options and the type of loophole represented by stock options are communistic in theory and communistic in practice.

We have heard of the commissars in Russia being the few people who own limousines, or at least ride in limousines. And we hear the commissars having dachas, or large country houses, while the remainder of the population live in small cramped houses.

We have here in this country a class of corporate bureaucracy that, I believe, is repeating the errors of the communistic system. And they are also repeating some of the errors that have led to unstable governments in other parts of the world.

There is a saying that the only real millionaire left in the world today is the Greek millionaire, because he doesn't pay his taxes. The

only fellow who can afford to run a 150-foot yacht is a Greek shipowner, because he is not paying his proper share of the taxes.

The stock option loophole represents a swindle of the American people.

And I have the pleasure of being in the position of saying, I told you so, because as a practicing lawyer I have been involved in a good deal of corporate litigation. And in 1952 I was involved in litigation on the early stock option plans with Standard Oil, United States Steel, CIT Finance Corp., and one or two others.

And most reluctantly I became the one who placed the judicial stamp of approval on those plans.

And the judge usually rested their opinions as to the legality of stock option plans on the fact that, since Congress had said it was a good thing for American business, because it increased incentives and increased proprietorship, therefore, it must be a good thing for American business, regardless of how it may seem to violate the principles of corporation law.

In testifying here as an attorney, I am sticking my neck out, because—and it required an office conference before it was determined in good conscience that I should offend the corporate bureaucracy by stating these views.

I am almost as reckless as Dean Griswold is, or was, when he also indicated his opposition to stock options, as well as to the oil depletion loophole at the same time that Harvard University was trying to raise $82 million, and succeeded in raising $82 million, a good portion of which undoubtedly came from big business.

Now, the first justification of these plans was that they were supposed to make the executives partners in the business. That has gone so far by the board that Allied Chemical recently put in its proxy statement a proposal that it would no longer require the optionees to hold stock for "investment purposes." In other words, back in 1951 and 1952 and 1953 these stock options plans were sold to the stockholders—if they understood them at all, and I can't believe that this Congress ever understood what they were enacting when they enacted this in 1950—they were sold to the stockholders on the basis that the stock would be taken and held for investment purposes.

Now, they are frankly coming out and eliminating that from the stock option plans, eliminating it from existing stock option plans.

As people have pointed out earlier this morning, stock option plans represent a heads-I-win tails-you-lose proposition, a Monday morning quarterback, who can call the plays after the game is over.

But even this isn't enough. Assuming that the corporation has done badly, management is so piggish and they have so little opinion of the intelligence of the American stockholders and the intelligence of the American public, that they then, if they find that the company has done badly and the stock has depreciated in value, they then issue a new stock option plan at the lower value. The rank and file of stockholders, who may have bought their stock at $40 a share when the first stock option plan came out now find they have got a $20 loss, the stock being now worth $20 a share. But management issues new options and, if the company fares better, or if the general economy fares better, the stock may go back up to $40 a share. The stockholders have

no profit at all, but the management now has a nice fat profit of $20 a share, with no risk, not a dime on the line.

Now, I can't do that in my law practice.

If I get a big fee this year, I can't postpone it until I retire, I have to pay taxes on it.

As Mr. Carey said, the workingman with his modest income must pay regular income tax rates. Here are these fellows who need it the least who have all these other benefits, such as deferred compensation—and this is a frightful loophole which the Congress should give its attention to. A corporate executive who has a cash salary of $200,000 for this year, is permitted to take $100,000 this year and then take the remaining $100,000 as deferred compensation after he retires from the corporation, and after he is in a lower tax bracket.

In other words, they have plans now, in addition to stock options, where they get wonderful six-figure salaries, half of which, or perhaps less than half of which, is deferred until retirement, so that a man who is today 55 years of age, and is earning $200,000 a year, can take $100,000 of that for the next 10 years, then he retires, and then for the 10 years after retirement he gets a low tax rate, or comparatively low tax rate on the remaining $100,000.

I merely mention that to highlight the greed and the inequity of this loophole.

As Senator Gore states, it is just this kind of thing, when it is finally realized and appreciated by the general public, that leads the general public into complete disrespect, into the feeling that they are being made suckers of.

And that just isn't the American way of doing things, and I don't think that the American public can ever develop an aggressive philosophy and a philosophy of integrity under these circumstances. We have our magazines like Life magazine writing pompous editorials about the American philosophy, what the American philosophy should be. They would be doing a great deal more to help the American philosophy if they eliminated inequities, and this particular inequity, which is just insulting to the intelligence of any modern society.

Now, how do these stock options operate in time of national crisis, or in time of war?

If a man has a million dollars profit in stock options, will that be regulated along with wages, salaries, and prices in times of war or other emergency, in order to avoid inflation?

Now, it seems perfectly obvious that a man who has a million and a-half dollars in capital gains, and can take it by only paying 25 percent tax, is going to have a much greater capacity for promoting national inflation than some laboring man, or the average business or professional man. But, fortunately, we have a blueprint as to how stock options are treated in times of national crisis.

Back in 1952, or 1951, during the Korean crisis, the salary stabilization board held special hearings as to whether stock options should be regulated, since everybody else was tightening their belts, and since American soldiers were freezing to death in Korea and since prices were being regulated, salaries and wages were being regulated. The thought was that perhaps these capital gains should be regulated, too.

I recall a meeting of a special panel that was called by the New York City Bar Association in 1951, I believe it was, when we were all

worked up about the horrible North Korean Communists, and the American soldiers were going back 6 years after we were there in 1945, and everybody was patriotic as could be, and everybody should have been as patriotic as could be.

I remember Mr. Arthur Dean of Sullivan & Cromwell, who subsequently became one of the negotiators with North Korea, doing some hairsplitting to justify stock options as not proper subjects of regulation even during a national emergency. And I remember him saying—and he was quoted in the newspapers as saying—in substance, that it was just too complicated and too expensive, that while there were abuses, and there might be abuses, from the point of view of a national emergency and a national crisis, it was just too complicated to regulate these things.

You could regulate baseball players' income, and lawyers' income, and everybody else's income, but not restricted stock option plans, and not capital gains that were then existing of a million or a million and a half dollars.

Now, this is precisely the thing—I suppose if you assume that the American, average American, is so stupid that he can't understand a stock option plan, or he can't understand the inequity of it, why then go ahead and keep the thing in the tax law. That is the assumption that the Greek Government runs on, and the Greek millionaries. And it is probably the assumption that the Latin Americans run on the rich avoid their taxes in every way, the poor pay the taxes.

And now we know what an explosion we are sitting on all over the world because of these inequities.

If you assume that the average American has average intelligence, and that you can't fool all the people all the time, and that some American soldier who perhaps happened to go to law school is sitting there freezing in a mudhole and he tells the other fellows, "Gee, whiz, I just read in the papers that the stock option plans are not being regulated"—I was saying, Senator Gore, that we have a blueprint as to how the corporate bureaucrats will tighten their belts in times of national emergency because we had that problem already in 1951.

And the salary stabilization board came to the conclusion—I believe they came to the conclusion—that stock options should not be regulated.

Now, the whole business about attracting new personnel and retaining old personnel is sheer hokum.

In the first place, the options don't go to new personnel, they go to new personnel on a picayune basis. And in the second place, it is a circuitous argument, because if you don't put this thing into law, nobody would be able to attract anybody with any stock options.

As far as the oldtimers are concerned, they grab the lion's share of the options. Irving Olds of United States Steel a year or 2 before retirement——

Senator GORE. If no corporation had this privilege, then it wouldn't be a problem for any corporation, would it?

Mr. KAUFMAN. Absolutely not.

Now, Dean Griswold just pointed out that the companies who need it the most, probably, in this rat race that Congress has created, the companies who need it the most, the small companies, can't take advantage of it because of certain technical problems which you are

probably aware of. But if you are going to keep this loophole, which is frightful and horrible and immoral and bad for the American conscience and bad for American standards, it might conceivably be part of small business assistance, part of the Small Business Act to enable small business to provide what conceivably might be some special inducements to get executives away from large corporations and possibly equalize things that way, although I don't think that is feasible. I don't think it is practicable. I think that the kind of men who go out and start new businesses in the old-fashioned way, and who take risks, are not the corporation bureaucrats. They are scared to death.

In spite of their protestations about meeting payrolls, most of these follows have never met a payroll personally. They have just come out of school, or wherever they were; they have stayed as members of the team, and they have no concept of any of the real old-fashioned American competitive system where a fellow has an idea and puts his own money on the line, builds up a business by himself. They are inheritors of businesses usually from the old tycoons who had the guts and the imagination and the ability to build up these businesses.

The very fact that they won't buy the stock of their own corporation but have to take options indicates that they have no guts.

What happened to these GE executives that were fired as a result of the antitrust thing?

They are running around in circles looking for jobs. They weren't in such great demand. It wasn't necessary for anybody to give them stock options to attract them.

I followed them in a vague sort of way, their future, in getting new jobs. And most of them took jobs that were a lot worse than their jobs with GE. And I suspect that they were companies that did not have stock options.

Now, you might ask, do stock options really help the companies? Do they increase their earnings?

They do not increase stock market prices, because stock market prices are not the result primarily—are hardly the result of corporate executives' activities. When the stock goes down, then the executive says, "It was due to world conditions or conditions in the industry or an unfortunate thing, it had nothing to do with my efforts at all." When it goes up, of course, then, this has everything to do with their efforts.

I have an article from the New York Times of June 4, 1961 entitled "Drop in Earnings Faze Blue Chips." And the New York Times points out that from 1956 to 1960 the earnings of the 30 largest common stocks on the New York Stock Exchange, that is, the earnings on one share of each fell a little from $1.0594 to $1.0537. But stock prices of these institutional corporations advanced approximately 33 percent.

I think if you examine those corporations you will find out that most of them are corporations with stock option plans.

In other words, the stockholders haven't gotten any more dividends, the company hasn't gotten any more earnings. The market rise is caused by public speculation or a public psychology.

And the price-earnings ratio has increased. Whereas stocks in 1956 were selling for 14 times earnings, I believe that they have advanced—or 18 times earnings—I believe that—well, I don't have the specific figures here, but let's assume they were selling for 15 times earnings in 1956, and they advanced to 24 or 25 times earnings in 1960.

And as this article points out, the general market on listed corporations on the New York Stock Exchange advanced much more than these 30 institutional corporations.

I suspect that if a study were made you would find that the earnings and dividends of corporations without stock option plans probably did just as well as, if not better than, ones with stock option plans, because stock option plans don't make a fellow work harder. If he has his million and a half, his million dollars, or million and a half dollars, he then feels, "Why, I have made my pile, I might just as well relax."

The next stock option plan comes along, and he says, "I will take on more stock options."

I was saying that the options went primarily to the oldtimers who really had very little corporate use left and who were on the verge of retirement.

I recall the situation with Irving Olds, the chairman of the board of United States Steel, who was making a huge salary just before his retirement age. He was also getting, I think, deferred compensation, a large pension, a big expense account, and everything was just fine. And along came the stock option plan, and just a short time before he retired he was made a substantial participant in the stock option plan. His only duty left after retirement was a very fat management advisory function which he could do in his spare time to justify his postretirement pay.

He was also presumably getting legal fees from his firm, White & Case, which was general counsel for United States Steel.

Now, nobody objects to men making big salaries if there is a progressive income tax. Nobody objects to men making huge capital gains if they lay their money on the line and lay their ability on the line. But for people to make capital gains without any risk is offensive, just offensive. It is bound to be found out by the American public.

I am surprised that the Republican members of this committee show as little interest as they do, because Senator Gore's proposal really involves the good old-fashioned principles of ethics and morality, those principles that rugged individualists are supposed to stand for.

Senator McCarthy. You don't mean that the Democrats don't stand for it, what you mean is that the Republicans talk about them more.

I just want the record clear. We wouldn't concede that to the Republicans.

Mr. Kaufman. They talk about them, and in the public mind they stand for them, and if they want to preserve that illusion it seems to me that they ought to——

Senator McCarthy. So long as you say it is an illusion, I will let you go on.

Senator Gore. Do you want to venture a guess as to how many Republican members of this committee will vote for my motion?

Mr. KAUFMAN. I am not a psychoanalyst, Senator Gore. I just don't know.

Senator GORE. Let's don't antagonize them.

Mr. KAUFMAN. I was not trying to do that, I was trying to show the opportunity of corporate bureaucrats—and, they should stop being bureaucrats. They should try to be a little bit more like the men who founded the corporations, and just not the way a Russian commissar is, just grab, grab, while the lawyers—and I have been one of them—try to figure out how many angels can stand on the point of a pin, to make black white, because this loophole is just the blackest thing, no matter how you may try to justify if piecemeal.

The assumption is that Robert McNamara is going to work harder for Ford Motor Co. because he has got stock options than he will as Secretary of Defense in a national crisis where he has no stock options and he has a low salary.

I think that is an absolutely invalid assumption.

Senator MCCARTHY. I would suggest that these same people, when they are talking about their own salary and their own security, say that the only way you get a man to work harder is to give him greater incentive and greater security. But when they are dealing with the working men they generally say, "If you give a working man too much salary and too much security, then he lies down on the job."

There seems to be a different psychology when you are dealing with the workingman.

A few years back they were saying, "What you probably need is more empty dinner pails."

If we were to take the empty dinner pail and apply it to the top, why these fellows would really work hard, we assume.

Mr. KAUFMAN. Yes; so we assume. There is no fighter like a hungry prize fighter, they say.

Senator MCCARTHY. That is what they say. They say they do not fight so well when they face the income tax collector after they fight.

Mr. KAUFMAN. That is true, they don't fight as often, they may fight as well.

But I think that what the Senator has said is really an unconscious expression by corporate people of an alien and European psychology, that there is a difference in quality of character between the workingman and themselves, that one fellow is going to get drunk and lay down on the job, and the other fellow will just drink moderately in his country club and pass valuable ideas back and forth for tax deductible expenditures. It is really, I think—I think it is communistic

Senator GORE. You don't mean communistic in ideology, but a practice of favoritism practiced by a select few?

Mr. KAUFMAN. Well, to the extent that—I don't know, Senator Gore, you were out of the room, I think, when I was trying to describe my conception——

Senator GORE. No; I was here.

Mr. KAUFMAN. Of the favored few.

The Russians are all tightening their belts, presumbly except Khrushchev, who probably wears a size 40 belt, and people like him, who get special privileges. They are bureaucrats. Now, these fellows are not businessmen.

General Motors and General Electric are like a government in themselves, the size of them, the way they operate.

Senator McCarthy. Maybe we ought to give them diplomatic recognition, and let them fly their own flag and send ambassadors.

Mr. Kaufman. They would be valuable allies, Senator.

Senator McCarthy. Like the Greek shipowner, give them sovereignty and then negotiate.

Seantor Gore. I want to be the consular representative.

Mr. Kaufman. Well, you will be royally treated, I am sure.

Thank you, Senator Byrd, and members of the committee, for listening to me.

If you have any questions, I would be glad to try to answer them.

The Chairman. Thank you.

(The statement referred to is as follows:)

Statement of Stanley L. Kaufman, Esq., New York, N.Y.

It is very rare that one has the opportunity to say, "I told you so," on a major national issue. Since shortly after the stock option loophole was placed in the tax laws in 1951, I have been strongly critical of this unfair and inequitable shifting of the tax burden from one American citizen to another.

In a little book I wrote in 1955 entitled "Your Rights as an Investor," I stated that corporate managements, like most people, resent "working for the Government." To relieve their general suffering their highly paid tax lobbyists slipped a beautiful little loophole into the tax laws in 1950 known as restricted stock options. Restricted stock options are one of the last remaining ways of becoming a millionaire under present tax laws without investing a nickel. These options are "restricted" primarily in the sense that most of us will probably never receive any.

My firm represents and has represented management of listed corporations, yet there are times when the conscience must speak out, particularly when national interests and morality are threatened. I believe that the primary difficulty with stock options is their basic immorality. One of the early apologies for a stock option was that corporate executives were taxed at so high a rate (because they made so much money) that they did not have the opportunity to build an "estate." If this be true, then every American taxpayer should have the opportunity to build an "estate." Corporate executives should build estates by saving their money in the good old-fashioned way, or by providing insurance for themselves like other citizens and not by gambling on the stock market—which is essentially the way money is made in stock options.

There is no point in saying that stock options are so technical that most American citizens do not realize they exist and therefore what harm can they cause? Truth has a way of coming out. Continually corrupt pinpricks in our national character tend to split class from class, labor from capital, and tend to make us a copy of the type of cynical governments that we find shaking with instability in other parts of the world. It is only natural that the laboring man or the small- and medium-business owner or the professional man must feel intense mistrust when they finally come to understand that they have been made "patsies" for a special privileged class of taxpayer. When he reads foreign and leftist attacks on our "ruling classes" and "privileged few," his mind has already been conditioned to believe this propaganda by such special-privilege legislation as the stock option loophole.

Life magazine can write articles about the need for "a new American philosophy" from now till kingdom come. Such a philosophy will never be created on Madison Avenue, by tax lobbyists or by magazine editorial writers. National integrity and purpose can only be achieved by conscience and fairness and by old-fashioned morality.

Back in 1952, I handled litigation on behalf of minority stockholders and against the managements of Standard Oil Co. of New Jersey, C.I.T. Finance Corp., and United States Steel Corp., attacking the early stock option plans. My attack was from the point of view of violation of corporation law, and in almost every respect the position of the management was sustained by the courts and they placed a seal of approval (at least corporation-law-wise), on

further stock option plans. In many cases the argument was made by management and adopted by the courts that stock options must be a good corporate device since the Congress of the United States had authorized them in effect by granting the tax loophole (of course, the word "loophole" was not used), and various phony arguments were used by management which I had the opportunity of making the prediction would subsequently be proven phony through actual experience.

In the first place, it was argued that it was important to make the officers and key executives "proprietors" and "partners" in the enterprise. Aside from the fact that they could very easily become partners and proprietors by saving their money and buying stock, the way all other stockholders had to, this argument was on its face ridiculous and experience had proven it to be ridiculous. These early plans were described as being "for investment purposes." In other words, management argued that the stock purchased under options would be held for an indefinite period of time as proprietors and partners and for investment purposes. We predicted that this was just not so and that it would be insane for a man to buy optional stock and hold it indefinitely. The sensible thing would be to wait until the price went up to the point where you thought it was not going to go any further and then exercise your option, buy the stock, hold it for the minimum period of 6 months, sell it, and reap long-term capital gains. In the end, therefore, you would own hardly any more stock than you did before the stock option plan. These plans were sold to the stockholders on the foregoing false premise. I remember in one case pointing out to the chairman of the board of one of the larger companies that the key executives who had been granted options to buy so many shares of stock that they could not possibly have the financial resources to purchase the stock on exercise of their options; that they would have to take bank loans when they exercised their options; and that these bank loans would have to be paid off, and further, that the only safe way of paying them off would be immediately after 6 months to sell the stock, pay off the bank loans, and take profits. I remember this gentleman very weightily putting his fingertips together on the witness stand (when I asked him what investigation he had made into the savings and personal financial resources of the executives to take advantage of the stock options), and he stated that many of them might have rich relatives or be able to borrow long-term money from friends in order to purchase the stock and hold it for an indefinite period of time.

A clipping that I have in my files from the Newark Evening News, a New Jersey newspaper, for April 29, 1952, indicates that in response to our question as to whether the executives would actually hold their stock since the plan did not provide for them to hold their stock, a director of Standard Oil of New Jersey stated that there was "an understanding" between the company and 80 keymen already given options that they will buy the stock for investment. We pointed out to the court that this was no guarantee that the men would not exercise their options to realize a quick profit, and Standard Oil counsel threw up his hands in horror at any such suggestion. I have not followed Standard Oil, but Fortune magazine in December 1954, pointed out that with regard to C.I.T. Finance Corp., which had also assured the stockholders that the proprietary interest of the executives would be increased and that the stock would be held for investment, shortly after the plan was declared legal in the Delaware courts, most of the large recipients of the C.I.T. options proceeded to sell and make quick profits, which in our opinion was in violation of the stated purpose of the plan. I am sure that this committee has a good deal more material than I have concerning abuse of the investment intent and immediate sale and taking of profits.

How about the inflationary influence of these plans? Obviously, an executive who only pays 25 percent on his profits will have considerably more money than had he paid 75 percent tax on his profits as salary. What happens in time of war? Are stock option profits regulated like salaries? While young Americans are dying and while the salaries and wages of workers are being regulated and while prices are fixed, are stock option profits regulated? We are an honest, patriotic, and moral people, and the answer to the foregoing questions should be "Yes." Unfortunately, we already have a blueprint as to the treatment of stock option profits in wartime.

During 1951, I made a statement before the committee of the Salary Stabilization Board, which was seeking to determine whether stock option profits should be regulated during the Korean crisis. I stated that stock options were "a daisy chain of inflation with each company contending it had to adopt a stock option

plan to keep from losing its executives to other firms that have such plans." See New York Herald-Tribune, Aug. 9, 1951.) Mr. Arthur H. Dean of the New York law firm of Sullivan & Cromwell stated, on behalf of corporate managements, that he thought that there might be abuses of such plans, but that it would be too expensive and too complicated for the Salary Stabilization Board to attempt to regulate them. I believe Mr. Dean was later one of the negotiators between North Korea and our forces toward the end or after the end of the Korean crisis.

How cynical can you get? There hasn't been much publicity on the foregoing, but how will an American soldier freezing in a foxhole feel if he is smart and sophisticated enough to understand this shell game. How hard will the laboring man work and how patriotic will he be in a national crisis in view of the foregoing? We can't be cynical and assume that these little people are so stupid that eventually they don't get the point. The result during the Korean crisis was that stock option profits were virtually not regulated. Apparently, long-term capital gains in the hands of rich men are not inflationary whereas small wages or small moderate income in the hands of laboring men, small businessmen, and professional men are inflationary even though the latter are taxed at ordinary income tax rates.

We also were met with the argument that it was necessary to have stock options in order to attract new personnel. The answer to this was simple. It was difficult to understand how management would have the nerve to make this argument, but they did. In the first place, if no company used stock options, then no company would have to attract new personnel from other companies by the use of stock options. Once you enacted the stock option loophole, you had an endless chain of possibilities of "raids" on personnel. But more important than this is the fact that the bulk of the options have gone to oldtimers, presidents, executive vice presidents, et cetera. We are familiar with one situation in which 10 percent of the company was optioned—and it was a company listed on a national stock exchange—and the top man grabbed one-half of the options. The board of directors got most of the rest and the lower echelons got practically nothing. Then the argument was used that incentive of executives would be increased and they would work harder and do a better job for the stockholders and the public. This, too, is hokum. An article in the New York Journal-American dated April 24, 1961 by Leslie Gould, the financial writer, indicates that numerically public utilities did better than most companies that had stock option plans. The following day on April 25, 1961, Mr. Gould published a study concerning stocks which have declined in recent years, and I do not believe there were any public utility companies (no options) among them. Unfortunately, one of the last acts of the Securities and Exchange Commission under its previous administration was to approve the use of stock options for public utilities. One hopes that this action will be reversed by Mr. Carey, the present Chairman, as it will release a flood of unnecessary stock options in utility companies, will probably adversely affect rates for electricity and gas and probably will also lead to stock market manipulative practices in the case of listed public utility companies.

The theory of stock options is also based upon the fallacious assumption that Mr. Robert McNamara will work harder as the head of Ford Motor Co. than he will as Secretary of Defense or that the corporate executive with stock options will work harder than a member of this committee who is working for the Government or that a corporate executive who is receiving a large salary, a pension when he retires, a large expense account and other benefits, including deferred compensation, will work an infinitesimal bit harder if he also is receiving stock options. (As to deferred compensation, here is another unfair and inequitable loophole in the tax laws. Why should a corporate executive earning $200,000 a year be permitted to defer $100,000 of this until he retires, at which point he will take it at a lower tax bracket? Baseball players cannot do it. Prizefighters cannot do it. If I get a big fee this year, I cannot postpone paying taxes on it until I am 65 years old. In my opinion, deferred compensation is a form of constructive receipt and should be taxed or should not be permitted.)

The argument made by corporations that stock options were necessary in order to hold valuable executives within the organization was as phony, if not phonier, than the argument that they were needed to attract new talent. In the first place, established executives rarely go into private enterprise. They are usually scared to death to do so. They are organization men in spite of all their protestations of rugged individuality. Most large institutional corporation executives, contrary to their tiresome refrain, have never actually "had to meet a payroll"

nor have they ever personally met a payroll. As a practical matter, they just do not leave safe corporation berths to start new and speculative businesses with their own money or even with someone else's money. Furthermore, as I mentioned above, if you never had any stock options, stock options could not be used by one company to attract executives of other companies. The type of executive who has the guts to start a new enterprise—the old fashioned tycoon—is pretty rare in corporate circles these days. Now, when a corporation executive loses his job, he usually goes running desperately around to other corporations in search of a new one. The man with initiative and a really new idea builds his own company by investing money and time and does not worry about stock options.

This committee can easily send out a few hundred questionnaires to listed corporations to determine how much optioned stock has been held for more than 1 year after exercise and how much has been sold. I am sure the results would be shocking.

While it may seem a bit silly to lock the barn door after the horse has been stolen, perhaps only three-quarters of the horse is already out of the barn, and we still have time to save the rest.

The CHAIRMAN. The next witness is Col. Lawrence I. Peak, of California, Md.

Will you take a seat, sir, and proceed.

STATEMENT OF COL. LAWRENCE I. PEAK, CALIFORNIA, MD.

Colonel PEAK. I appear before you today not because I am opposed to stock options, but because I am opposed to the abuse of stock options and their equally vicious companion pieces, the so-called employment or consultant contracts, the latter rapidly becoming more dangerous to stockholders than the option agreements.

I would like to emphasize that whatever action is taken in connection with stock options must also consider these employment contracts. Already management has sensed the opposition on the part of the stockholders to option agreements, and more and more companies have granted these so-called consultant contracts which mortgage the future of the companies for many, many years in advance. They apply not only to the optionee, but usually to his wife, and I have seen some instances where they go down to the children, the minor children.

As one consultant passes out of the picture, and somebody takes his place, that man is going to expect the same type of employment contract. As a result, that company's earnings are going to be mortgaged for an indefinite time in the future.

As I am sure you are aware, stock options came into being to reward management for exceptional performance, and because of unwise tax legislation, to permit management to legally retain greater sums of money than was possible from straight salary payments. It was also intended that by having an ownership interest in the company, management would exert greater efforts to have it prosper. From this laudable beginning, the stock option proposition has been exploited to the point where in some companies it appears management is more interested in the action of the company's stock than it is in the operation of the company.

In those few instances where stock options have been challenged, it is usually represented by management that the stockholders in general have by their votes approved the granting of stock options. This is a pretty fairy tale when the facts are considered.

In most instances stockholders have no knowledge that a stock option has been granted, or its terms, until the notice of the annual

meeting is received. This is usually 30 days before the actual meeting is held. This does not give any stockholder the time to prepare and submit to the SEC a resolution regarding the stock option or to organize any effective opposition. He cannot submit a resolution to the SEC bringing this matter to the attention of all stockholders because of the time element.

Coupled with this element is the fact that any proxy contest is very costly and difficult even when adequate time is available to organize it.

Then there is the further fact to consider, that management is usually well supplied with proxies, because it is almost unheard of that the fiduciaries and trusts vote other than in support of management.

In addition, there are many thousands of uninformed, ignorant stockholders who either send in unsigned proxies or fail to express any sentiment.

In recent years in many concerns stock options have been granted by the so-called insiders in fantastic amounts which have no relation to the value of the services rendered or the ability of the recipient to pay for the stock. As a result, in most cases the holder of the stock option sells the stock as soon as possible and thereby defeats the entire thought behind the stock option. Such sales of course depress the market, for the time being at least.

I have long opposed the granting of unreasonable stock options or consultant contracts and, as a means of exposing this racket, I have endeavored to have the SEC require companies to show in their notice of annual meeting, the total amount of stock granted under options, the amount of stock taken up, and the amount retained, of all principal officers.

The present procedure does not give the stockholders any means of forming an enlightened opinion on how much stock the optionee has obtained over a period of time.

As I have stated, I am not opposed to stock options, but believe the following conditions should be incident to such plan. In making this statement, I might say that I belong to the old school that feels that when a man accepts employment, whatever his salary may be, he owes a certain allegiance to that company and should give his best efforts to the company.

Senator GORE. And should not expect or require additional incentives?

Colonel PEAK. That is my position, sir.

Senator GORE. It is really, it seems to me, insulting to the corporate official, to say that he will not give his best to a company whose employment he has accepted, generally at a very handsome salary, unless the company gives him something in addition?

Colonel PEAK. That is my position, Senator.

Senator GORE. I just cannot understand how people can argue that this is necessary from a standpoint of incentive.

Colonel PEAK. It has been my experience that management, speaking in the general term today, regard their salary merely as a retainer, and they look to their stock options as a bonus, or means of creating some income.

I think——

Senator GORE. As a means of getting income without taxes.

Colonel PEAK. That is correct, sir.

The conditions I believe incident to the granting of any stock option are as follows:

1. The grantee should have contributed something to the benefit of the company above and beyond what should be expected from his position.

2. No stock option should be granted in any year when no dividend is paid to all stockholders.

3. Stock granted under option should be from previously issued and outstanding stock.

4. That stock granted under option should be held for at least 5 years and only in cases of extreme emergency, and then only with the consent of the directors, should the optionee be permitted to dispose of more than 20 percent of the optioned stock in any one year.

5. That the amount of stock granted the optionee should be in relation to his ability to pay for the stock without having to sell it in the market to exercise his option.

Senator GORE. Let us think about that just a moment.

It may not be necessary for them to sell it. If I have an option to buy for $100 a share which has a current market value of $200, would it not be possible for me to take my option to my banker and obtain the credit necessary to buy that share?

Of course, thereafter, in using this as collateral, it may not be necessary to sell the stock at all, or to sell anything, for the holder of an option to exercise that option.

Colonel PEAK. The point I tried to bring out, Senator, is that the amount of stock granted this man should be within his ability to pay for it, without having to hypothecate or pledge the stock, or anything of the kind.

For instance, I could cite one company locally in which the executive was receiving $60,000 a year. He was granted an option of 10,000 shares of stock at something over $20 a share. I happened to know the circumstances of that man, and without either hypothecating the option as you have indicated, or some other device, he could not possibly pay for that stock without selling some of it or making some arrangement for financing it in another manner.

Now, I think the man should pay for it out of his earnings.

Senator GORE. I do not know that I would agree with you on that particular point.

My primary concern is twofold:

One the morality and inequity of permitting the corporate insiders to water and dilute the stock of other people who are not in such sanctuary;

Second, the inequity and unfairness of the tax treatment by which compensation is received under conditions which place it beyond the normal tax rates, or in case of retention up to death beyond any income tax application at all.

Now, these are the two primary concerns I have, both of which, it seems to me, bring into question, and perhaps hold our tax laws up to ridicule and derision by the mass of our people who have no gimmick of favoritism, who must pay, and who feel that everyone else is likewise paying, a fair share of taxes at the time.

Colonel PEAK. Let us explore the situation that you outlined, where the man goes to his bank and borrows. Sooner or later—there are only two ways that I know of that he can pay for that stock. He either must pay for it out of his earnings, or must sell a certain amount of stock to liquidate his bank loans.

Senator GORE. That may not be true, because he might use the stock as collateral and let the dividend from it pay for the note.

Colonel PEAK. Senator, you have raised a point which has already been a sore one with me.

When I pick up a financial statement and I see that the tax bite is something like $5 a share, and the income after taxes $2 or $3 a share, I think he would be quite a while paying for that out of his dividends. It might be possible——

Senator GORE. A man who buys GE stock at $23 could pay for it out of dividends.

Colonel PEAK. It would take quite a long while.

In my early days I was with a company, and in those days we received something like 20 percent per annum in dividends, and it was possible for us to acquire stock on just that basis. But today that company is not paying that rate of dividends.

The feelings among stockholders against stock options and consultant contracts is mounting with each year. However, it is something extremely difficult to combat and I was delighted to learn that Senator Gore and this committee at long last have taken the matter under consideration. I have a few exhibits I have hastily assembled, but due to the short notice given me of this hearing I have been unable to fully organize this material. It does, however, give an indication of the extent of this practice and the unfair manner in which those in control of certain companies have exploited the stockholders.

I am convinced that as long as stock options offer such profitable opportunities to management, they will never be willingly given up. However, they can be brought under reasonable control by—

1. Regulation by the stock exchange, and most of these inequities apply to stock that is traded on the big exchanges;
2. Regulation by the SEC;
3. Making them unprofitable from the tax standpoint; and
4. By corrective legislation.

Again, I urge that in taking action against the stock option abuse, coincident with it action must be taken with the so-called employment or consultant contract.

I would like to quote very briefly from some articles which I have received which will supplement to some degree the information already before this committee.

I have an article here, "And Now 'Instant' Millionaires":

The monthly Insiders-trading Report issued by the Securities and Exchange Commission compels disclosure of all transactions involving directors and the top executives. The last 2 months' reports list 627 cases of insiders buying on options.

Now, I would like to quote some of these:

Oil company president, 48,000 shares were given him under option of $14 a share. The same day the market price was $27 a share. As a result, without one cent of investment by that man, he had $625,000 profit, which, as the Senator has pointed out, is not subject to taxa-

tion, and might never be subject to taxation, until he chooses to dispose of the stock.

Senator GORE. Do you think the American people generally know this?

Colonel PEAK. No, sir.

If you will go to stockholders' meetings, as Mr. Gilbert has, and I have, you will find that among stockholders as a whole, they are extremely ignorant of what is going on within the corporation, and of their rights.

Recently an airline company in this city went bankrupt. For something over 5 years I endeavored to get before the stockholders the situation that needed to be corrected. I submitted resolutions to the Securities and Exchange Commission. In each instance these resolutions were opposed by management.

It has been my experience that the Securities and Exchange Commission are extremely management-minded. Management would come in and allege that my resolutions involved a question of management.

Now, that comes into the borderline category. What is a management decision?

If you are on one side of the fence, practically any decision is a management decision. If you are on the other side of the fence, it is the stockholders' right to submit this to the other stockholders, so they may express their sentiments.

I feel, and I firmly believe, that that company could have been saved from bankruptcy had these situations been brought before the stockholders and corrected.

I might say further that once they had gone so far that they were in a hopeless condition, with one exception every one of these suggestions was adopted by the management, who for something over 4 years had opposed submitting them to the stockholders.

With your permission, I will go on to some of these other instances. And they are rather frightening.

A grocery chain executive bought 27,750 shares at $13.21. The market value the same day was $32.50. The profit, $550,000, again not subject to taxation.

An electrical company president bought 25,000 shares at $30. The market price the same day was $75, making an assured profit on the day of purchase of $1,125,000.

I could go on and quote numerous instances. I will file this——

Senator GORE. I would like for you to put that in the record, if you would.

Colonel PEAK. Yes, sir.

Senator GORE. May he have permission?

The CHAIRMAN. If there is no objection.

How many more will there be in the same category?

Colonel PEAK. I have a number here. I would just include them in the record.

The CHAIRMAN. It would be pretty cumbersome to put them all in the record. If you would select the ones that are more important——

Senator GORE. I think the one he was reading from ought to be in the record.

The CHAIRMAN. But he has a number of others there. I have no objection to it, except that the record should be kept at some reasonable length.

Colonel PEAK. Senator Byrd, these are not only factual, but they show the feeling among other stockholders who unfortunately are not in a position——

The CHAIRMAN. Are they very long?

Colonel PEAK. No, sir.

I would like your permission, sir, to quote from a letter I received——

The CHAIRMAN. I am speaking of putting them in the record. Are they long documents you have there?

Colonel PEAK. No, sir; they are very short.

The CHAIRMAN. If there is no objection—I thought maybe you had some long statements.

Colonel PEAK. With your permission, sir, I would like to read this extract from this letter:

> The first 20 years of my business life were spent in the investment business, after which I still spend much of my time indirectly connected with the same. And I never thought I would live to see the day where so much actual legal theft is practiced by corporation officers.

The CHAIRMAN. Anything that you do not care to read and that is short, there will be no objection to inserting it in the record.

Do you desire that other paper inserted in the record that you just laid down?

Colonel PEAK. With your permission, sir, I would like to have it done.

Senator GORE. If I may be so bold to suggest, the Chair would, in my view, be perfectly within the custom of this committee to have these exhibits submitted to the staff of the committee, and if they appear voluminous, or beyond reason, then they would not be included except with the specific approval of the chairman.

The CHAIRMAN. That is satisfactory. I just wanted to protect the record.

Senator GORE. I agree with you completely.

Colonel PEAK. There is just one more thing that, with the permission of the committee, I would like to include.

It is an article by Leslie Gould, financial editor of the New York Journal American, in connection with the operations of a certain director. It shows his stock transactions and how he took advantage of it.

These others, subject to the committee's acceptance or rejection, I will merely submit.

That will conclude my statement.

I will be very happy to answer any questions, if there are any.

The CHAIRMAN. Thank you very much, Colonel Peak.

Will you give these to the clerk, please?

And Senator Gore may look over them if he wishes.

(The information referred to follows:)

"and now 'Instant' MILLIONAIRES!"

Not since the Pecora investigations in the pre-SEC days, has any maneuver in the investment world carried such an alarming threat to the integrity of stock-market transactions as does the "Executive STOCK-OPTION Plan".

Started in a few high-powered concerns in the early 50s, it provides so obvious an advantage for company-insiders over investors-at-large (and over other tax-payers) that it was quickly embraced by hundreds of management groups, and, gathering speed, force, and size, it appears now that it will shortly involve almost every corporation whose shares are publicly bought and sold on the New York Stock Exchange. How many new millionaires it will make - or where it will end - is anybody's guess.

Cutting through the confusing legal jargon and the claims of noble purpose with which it is presented to shareholders, the Stock-Option Plan boils down simply to this:

> Even though company stock is available to all (company officials, and public investors) and traded daily on the stock exchange, Company Directors seek and get, through the option plan, authority to issue a special block of these same shares, the second block to be available only to company-insiders to buy on a risk-free basis, without going through the regular stock-market.
>
> The Directors then "grant" substantial blocks out of this special pool to favored company insiders, setting the price at 85%, 90% (sometimes 100%) of the price prevailing on the stock exchange the day the "grant" is given.
>
> This "grant" then becomes a legal contract, binding the company to deliver these shares at any time the executive decides to take them in the next five or ten years - at that price - no matter how high the stock market may move up in the meantime.
>
> The executive signs NO contract to buy - he pays nothing in, and he is under no obligation at all. If the market goes up, and he has an assured profit accrued to him, then he can move in and buy the shares. If the market goes down, he ignores the contract entirely - no penalty, no loss, no risk of any kind. He even stays eligible for new grants all over at the lower price - some plans provide for his price to drop automatically when the market drops. And an individual may have a number of grants going for him - consecutively, or at the same time.

But one thing all Stock-Option Plans have in common:
The executive can only WIN - never lose - under his one-way stock-option "grant".

HOW WIDESPREAD HAVE THESE OPTIONS BECOME? The monthly "Insiders-trading Report" issued by the Securities and Exchange Commission, compels disclosure of all transactions involving directors and the 3-top executives. The last two month's reports list 627 cases of insiders buying on Options - many of the country's best-known companies and most valued stocks are included. In the 627 cases listed, supplemental information from proxy statements shows the executives named had an assured profit before they put a single cent into their purchases, running from a few thousand dollars, up through $100,000, $300,000, $500,000 per person. Cases where an insider's advance profit runs over $1,000,000 turn up in almost every issue of the SEC Reports. These are approximate figures in a few recent cases:

Oil Co. Pres. Bought 48,000 shares at $14.00 (Market same day: $27.00)
Assured profit day of purchase was $625,000.00

Groc. Chain Pres. Bought 27,750 shares at $13.21 (Market same day: $32.50)
Assured profit day of purchase was $550,000.00

Elec. Co. Pres. Bought 25,000 shares at $30.00 (Market same day: $75.00)
Assured profit day of purchase was . . . $1,125,000.00*

Chemical Co. Pres. Bought 38,967 shares at $26.63 (Market same day: $50.50)
Assured profit day of purchase was $940,000.00

Chemical Co. VP. Bought 27,171 shares at $27.17 (Market same day: $49.87)
Assured profit day of purchase was $615,000.00

Drug Co. Pres. Bought 27,318 shares at $7.72 (Market same day: $50.00)
Assured profit day of purchase was $1,100,000.00

Mfg. Co. Pres. Bought 30,000 shares at $19.00 (Market same day: $52.00)
Assured profit day of purchase was $990,000.00*

(*Figures on these two cases subject to adjustment when new proxy statement is issued)

INSTANT MILLIONAIRES It is possible for executives who buy their shares AWAY from the Stock Exchange under Option grants, to get an immediate million-dollar head-start on investors who buy their shares ON the Stock Exchange. Business concerns have researched and produced many new wonderful things in recent years

But – aren't they going too far with 'INSTANT MILLIONAIRES'?

Keep in mind the huge benefits that insiders get from Stock-options is compensation in addition to their salaries, profit-sharing bonuses, pensions, retirement "consultant" fees, and many such executive fringe benefits. But the Stock Option is not tied up to any measure of executive accomplishment. The Stock-option's dollar value depends, not on company sales, profits, or earnings-per-share, but on the ups and downs of the public stock market, an entirely different thing, affected by many

diverse factors beyond the executive's control or influence. Where it is now fashionable to pay twenty, thirty, fifty times earnings, the investing public formerly paid about ten times. With little or no increase in earnings-per-share, many shares now show 300% to 500% gains in price-per-share. Many have doubled or tripled in price in spite of mediocre or even poor executive performance and earnings per share sharply down. Stock-options often pay lavish sums to executives who neither earn nor deserve them.

Directors claim they can no longer hire and hold executives without stock options. How did they operate before there were any options? If an executive can be lured TO a company with stock-options, he can be lured AWAY with bigger options elsewhere. And what about companies and organizations with no publicly-owned stock? Are they to get only the executive leavings? Clearly, the stock-option plan is used here contrary to good public policy, and it should be stopped before it gets completely out-of-control.

THE TAX LOOP-HOLE Options give corporation executives huge advantage over other tax-payers. If an executive were given shares of stock outright, as compensation for his services, the value of the shares would have to be included in his current tax return as income. But given big discounts on a larger number of shares (though the dollars-and-cents value of this compensation may be far greater) it need not even be mentioned in his current tax return. If the stock is sold in future years, it is subject then to capital-gains tax (maximum 25% - about the same rate a low-paid factory-worker or laborer pays on his net income). But if the executive puts the stock in his portfolio as a permanent dividend-paying investment - if he does not sell the shares - he pays the Government: NO INCOME TAX AT ALL.

This is a tax loop-hole big enough to drive a Brinks truck through - there are more than 2,000 concerns now giving stock-options - the amount of Executive Compensation that is given as discount, and thus escapes Federal Income Tax each year, is estimated at more than 2-1/2 BILLION dollars.

FINANCIAL FAIRYLAND How did this Financial Fairyland come about? Lay it to three groups: the public-at-large and stockholders particularly, who refuse to read, or are unable to think through, the things that affect their interests. A second group, who have experience and perception to see what is going on, but lack energy and courage to speak out - and last: those who occupy posts of high authority and responsibility to whom others must turn for leadership, but who simply do not lead, defaulting the influence and authority which could stop improprieties easily when they are small, and who lack the strength-of-purpose to face the issues effectively when the abuses have been allowed to grow big and out-of-hand.

Heads of large Mutual Funds who vote millions of shares, and other large institutional managers whose proxies can always be found safely tucked in management's hip-pocket at stockholders meetings - the security analyst and dealers organizations - the stock exchange governors - none of these have done much, if anything, about stock-options, though the important facts are there for them to see. The time is long over-due for all these to think about this, and speak out against stock-option abuses.

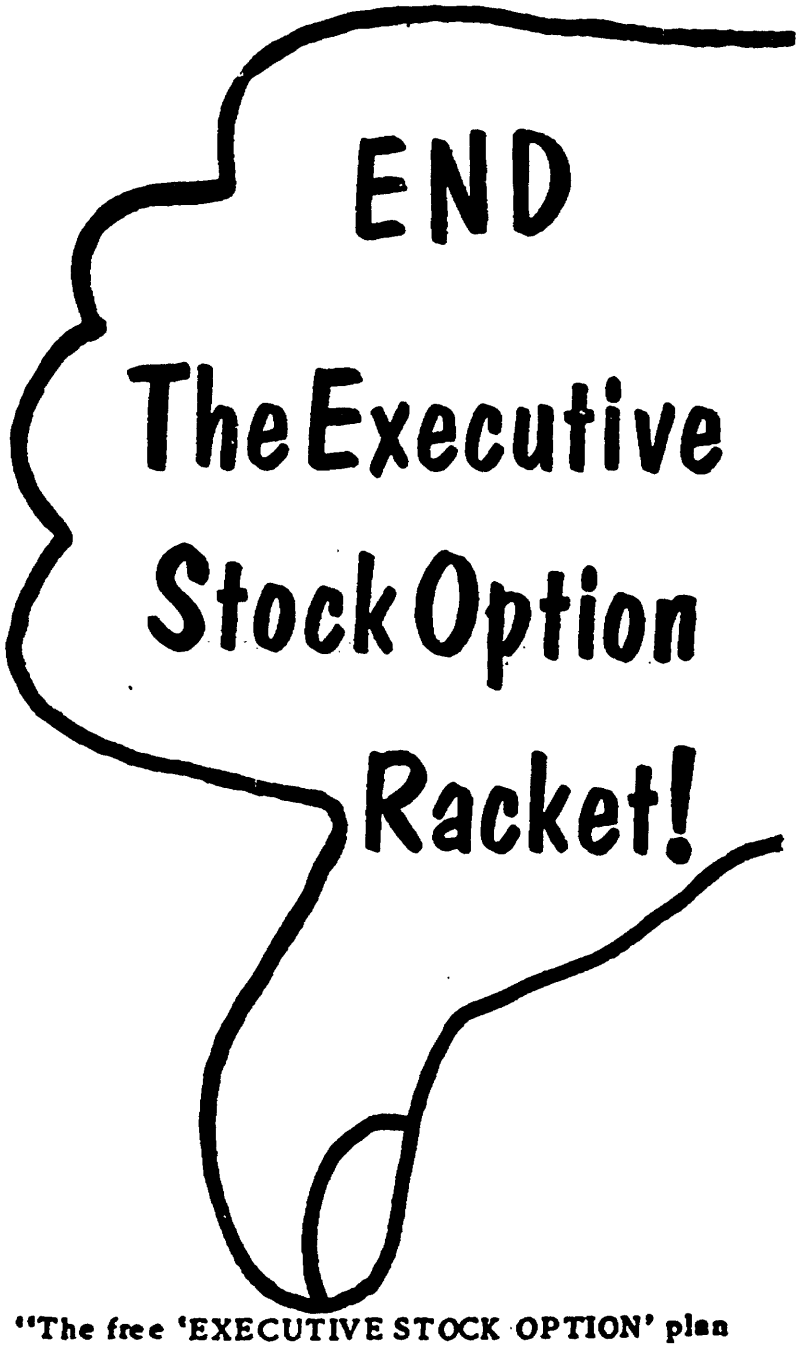
STOCK EXCHANGE GOVERNORS

Stock Exchange Governors could quickly end NEW option plans if they have the will to do so - they are the sole arbitors of new issues applying for listing and trading on their Exchanges. Nothing compels them to accept listing if any conditions are present which they deem to be improper or unfair to public investors. How can issues with Stock-Option Plans be deemed fairly traded, when privileged insiders with options, have access to the shares at cut-prices - far under the prices to be arrived at in open trading on the Exchange? Buying privately, and selling publicly is dangerous business - the potential for accidental injustice, or deliberate misuse, is appalling.

The authority of the Federal Government in areas of business and finance which affect the general welfare, has been clearly expressed in the Clayton Act, the Securities and Exchange Act, the 1935 Holding Company act, the Regulated Investment Company Act 1940, the Internal Revenue amendments 1950 and 1954, and many other actions.

It was inevitable that stock-options should come under the scrutiny of Congress. Senator Albert Gore (D-Tenn.) has introduced a bill in the U. S. Senate to review all aspects of stock-options, including the tax loop-hole, and it is hoped, quickly obtain legislation properly protecting all interests. The Gore bill merits support by every tax-payer and every share-owner - its need is urgent - it should be endorsed as "must" legislation by the Kennedy administration in any vigorous move to close tax loop-holes.

It is no good to pretend that there is no problem - or that left alone, it will correct itself. Even a casual observer can see it gets bigger each year. Every organization should put "STOCK-OPTIONS - good or bad?" on its agenda - dig into the hard facts - discuss them fully - and then take such forthright action as seems necessary.



"The free 'EXECUTIVE STOCK OPTION' plan is never equitable – stripped of its confusing legal wordage, its end purpose is to give a group of privileged insiders the right to buy publicly-held stocks at future cut-prices, with the guarantee of a profit before they put their money in. An improper advantage over investors-at-large, it UNDERMINES the whole business of the public investing in shares in American enterprises."

How long will independent investors put up with EXECUTIVE STOCK-OPTIONS?

If the Board of Directors at Belmont Park were to grant a group of their executives the right to buy a block of winning tickets on each race AFTER THE RACE IS RUN, the deal would be indignantly denounced from coast to coast, and those attempting to set up such a "sure thing" would be ruled off the American turf for life. "Fixing" or "rigging" is always an intolerable affront to America's sense of justice – in the sports world, in political or public affairs, in business or finance – in every area where man deals with his fellow-man, honesty and fair-play is expected – "deals" improperly tipping the scales in favor of one, against the other, are resented and rejected among right-thinking people.

Despite this widely recognized fact, in the recent few years, Directors of many leading business corporations have rigged up just such a questionable deal, using free stock options as a profitable sure thing for select leaders. Briefly, the plan involves setting aside substantial blocks of stock in the individual names of favored executives, who can then buy the shares ANY TIME IN THE NEXT TEN YEARS, at today's price, no matter how high inflation or other factors may push the market. If the market goes down, the option may be (1) simply ignored, or (2) cancelled without cost or obligation to the executive and new options written at a new low price – or (3) some plans now carry an R. F. D. (Reward for Decline) Clause, which provides: when the market declines 20% or more, the old option still stands, but the price is dropped down to the new low point and re-frozen there. Thus even a partial recovery from the low point, guarantees a profit to option-holders. Real share-owners may have severe losses, but option-holders never lose, only gain, in this one-way scheme.

With fine-sounding claims, Executive Stock Options are proposed in the fine print of the Annual Report and proxy-statement, which few read, fewer still analyze. Most stockholders attend no meetings, trusting their proxies signed in blank to management to vote, so no trouble is encountered in fastening this device on the investing public. Repeating it is proving just as easy – many are in their second and third round – in time, there will be nine, ten, maybe more rounds and dilutions, unless shareholders rise up and stop them.

Do you as an investor agree to setting up a special class of investors who, without putting up anything, are guaranteed profits only, while the rest of the investors actually put up their money, risking the downs as well as the ups of the market? Wouldn't YOU, too, like a block of stock set aside for you to buy any time in the next ten years at 85%, 95%, even 110% of today's price? If the market goes up, you may make a fortune – if it goes down, you take no loss. Yes, there IS such a financial fairyland – but don't get your hopes up – it is only for the favored few!

UNBELIEVABLE? Check through the first hundred Annual Reports you can lay hold of – study the details and extent of stock options and who gets them. Young, struggling executives who need encouragement to invest in, or stay with the company? Don't be ridiculous. Most of the options go to the top brass, many in the hundred thousand a year class, enjoying liberal incentives and annual cash bonuses, their jobs and income secured by life-time contracts. These well-paid executives could become substantial stockholders any day they have enough confidence in their company, their products, and their associates to buy the stock in the market as all other investors do, sharing with them the risks of ownership as well as the gains.

Wrong in principle, stock options are equally wrong in operation. What does an executive really get, when he gets a stock option? A *fair* and proper reward in keeping with his efforts? Or ten, twenty, fifty times what was intended? Who knows? The stock-option's dollar value depends, not on the company's profit or results, but the ups and downs of the public stock market, an entirely different thing affected by many diverse factors, and moving independent of, often contrary to, the company's affairs. Executives whose stock fluctuates wildly, with wide drops down then up, have windfall fortunes laid in their

laps – others, whose stock is sound, steady, and non-fluctuating, get no reward at all from their options. The potential for manipulation and mischief is appalling – and to police stock options against accidental injustice or deliberate misuse, an impossible task. Setting them up costs stockholders huge sums in legal fees, executive time and effort – indeed, from the time and attention given stock options, it is a wonder there is any time left for the company's regular business. But insiders are powerful, and stock options will not be ended except by the united opposition of an aroused investment public, trust-fund managers, security analyst and dealers groups, stock exchange Governors, and responsible Government bodies. The Revised Internal Revenue Code and SEC Regulations recognize that stock-options can be scandalously used, and some restrictions have been set up. To date they have done little to stop their spread – actually the rulings have turned out to be a convenient blueprint, of help to those who wish to put over option plans, and twisted around to imply that the Government endorses the morality and propriety of stock-option schemes.

The SEC was intended to prevent and stop exploitation – not to aid it. The Congressional Oversight Committee may well look into this, and if need be, strengthen the SEC to get the job done.

Every Board Chairman should call his Directors in for a sharp look at stock options. There is nothing they are claimed to do that cannot be done more fairly, efficiently and economically by other legitimate means. Most plans provide that they may be ended any time on motion of the Board of Directors – and that is precisely what perceptive and concerned investors are urging:

END EXECUTIVE STOCK OPTIONS AT ONCE!

What can ONE stockholder do?
MAKE YOUR VIEWS KNOWN. Write to:
- The Board of Directors of the companies whose stock you own.
- The Board of Governors, New York Stock Exchange, Eleven Wall Street, New York 5, N. Y.
- Chairman, Securities and Exchange Commission, Washington 25, D. C.

BRING UP STOCK OPTIONS FOR DISCUSSION IN investment clubs and other such groups.

BE SURE YOUR PROXY COUNTS. Read the proposals carefully—if management's proxy provides no way to vote your preference, use an "Independent" proxy form. Permission for any person or group to use, or reproduce by any method, the Independent Proxy form and other matter herein, is expressly granted by: "Independent Stockholders opposed to Stock-Options"

INDEPENDENT STOCKHOLDERS DIRECTED PROXY

CORPORATION *Meeting of Shareholders*

Proxy granted to: Dated_____

KNOW ALL MEN BY THESE PRESENTS, That the undersigned stockholder, hereby constitutes and appoints the person(s) designated above, or in the absence of such designation, then the Secretary of the Corporation, my true and lawful attorney and agent, and I hereby authorize such attorney and proxy, for me and in my name, place, and stead, to vote all of the shares standing in my name at the Meeting of Stockholders of above date and any and all adjournments thereof, except: on such of the following matters as may come before said meeting, the vote is to be cast and recorded as hereinafter directed, to wit:

ELECTION OF DIRECTORS: (
If cumulative – vote this stock FOR, or divide equally between: (
If non-cumulative – this stock is to be recorded: (
FOR: AGAINST:

(Proxy may not be voted either for or against "Management Nominees" unless so marked)

STOCK OPTIONS:
Vote this stock FOR: Any resolution to end stock options.
Vote this stock AGAINST: Any resolution to authorize, enlarge, or extend stock options.

EMPLOYEE STOCK PURCHASE PLANS:
Vote this stock FOR: Any plan in which employees may make firm purchase of company stock at the market, with low-interest loans secured by the stock, paid off by payroll deduction, limiting annual purchase and loan balance to 20% of employee's wage.

OFFICER OR EXECUTIVE EMPLOYMENT CONTRACTS:
Vote this stock AGAINST: Any resolution authorizing an employment contract with any officer or executive if such contract binds either the corporation or the employee for a period longer than three years from effective date of contract.

UNIFORM EARNINGS REPORT POLICY:
Vote this stock FOR: Any resolution calling for prompt reports quarterly, and requiring that all earnings reported to the stockholders and public shall include foreign earnings and earnings from wholly or partly-owned subsidiaries only to such extent that such earnings are received as cash dividends during the report period – supplemental information on increased equities in foreign and domestic subsidiaries, or explanation of consolidated tax returns, to be carried as subordinated foot-notes.

CUMULATIVE VOTING, PRE-EMPTIVE RIGHTS, and ELECTION OF ALL DIRECTORS ANNUALLY:
Vote this stock FOR: Any resolution calling for, establishing, or extending cumulative voting, pre-emptive rights for stockholders, and annual election of all directors as a single class, not as divided groups and not for staggered periods.

OTHER PROPOSALS:

Dated _____

Please sign exactly as name or names appear on your stock certificate. Joint owners should each sign personally.

THIS PROXY IS TO BE VOTED TO PROTECT, AND EQUITABLY ADVANCE, THE INTERESTS OF SHAREOWNERS.

ST. LOUIS, MO., *June 22, 1960.*

MY DEAR MR. PEAK: Thank you for sending me the material relating to stock options at Capital Airlines—you deserve the approval and support of all the shareholders there for your efforts, but without knowing anything about when their meeting was held or the results, I would venture to guess that management went into the meeting with 75 to 85 percent of the proxies tucked neatly in their back pockets, signed by shareholders in blank.

Frankly, I do not think the public is ready yet for independent shareholders resolutions on this matter. Let us face it—management has the tools—shareholders lists, efficient professional publicity experts, and the best legal talent on their side, all paid for by stockholders—and on our side we have only those of us willing to stick our necks out and pay our expenses out of our own pockets. There is a terrific job ahead of us to jar the public out of their lethargy. Our groups out here are pounding this matter constantly to the press, the various boards of governors of the stock exchanges, their public members, the SEC in Washington and elsewhere, our Congressmen to urge more aggressive attention by the SEC, to various mutual fund presidents, endowment fund managers, magazine columnists, etc. We must work hard for the break that will put this matter in the glare of publicity, and then after that, our proxy resolutions will have a chance to get much more than the 5 to 10 percent vote that our side is credited with. Of course, the regulation that permits management to vote for themselves all the blank or unmarked proxies, makes the elections usually just a sham. I hope too, that you will consider joining our groups in working for the end of the options. Trying to correct the defects and loophles is like trying to hold quicksilver in your hand—more escapes than is contained. There is an old law that states "a man must not beat his wife with a rod that is thicker than his wrist." If it were proposed that the law be corrected to provide he must not use a rod that is more than 1 inch thick—how would you vote? If we propose the end of stock options (as they are morally wrong) all the opponents of stock options could unite in working for that proposal.

You are 100 percent right on your concern over consultant contracts—this is a vicious form of feathernesting. Featherbedding is what labor does when it stretches out unnecessary work—but feathernesting is just as vicious a practice of management in setting itself up for life, and often 10 years beyond. Enclosed is a copy of an open letter our group sent to the stock exchange in 1958 on this very subject.

Good luck to you in your excellent work—if I can be of any srevice to you let me know. Until August 1, I can be reached here in Missouri—after that address me: 1313 Cochran Road, Mount Lebanon 16, Pa.

Yours truly,

LEROY F. KELLY.

PHILADELPHIA BULLETIN,
Philadelphia, Pa., April 16, 1958.

Col. LAWRENCE I. PEAK,
California, Md.

DEAR COLONEL PEAK: I appreciate your letter of April 11. I had written a previous article on stock options, with specific reference to Alcoa. I'm enclosing a copy in case you haven't seen it.

In my book, "The American Stockholder," I go into the question of post-retirement consulting contracts as well as other forms of managerial remuneration in considerable detail and at length. It was published only last month by Lippincott ($4.95). It's available, I believe, in most bookstores; it may be on the shelves of the public library.

I will study your Capital Airlines resolution regarding options. I expect to write more about the subject shortly—setting forth what I believe to be stockholder safeguards.

Sincerely,

J. A. LIVINGSTON.

[Reprinted from the Evening Bulletin, Apr. 3, 1958]

THE BUSINESS OUTLOOK—FAIRY GODMOTHER COMMITTEE CARES FOR ALCOA EXECUTIVES

(By J. A. Livingston, financial editor)

Stockholders of the Aluminum Co. of America, who suffered the humiliation of watching their stock drop from more than $120 a share to less than $70 in the last 2 years, may have read with mixed emotions the decision of the corporation's top executives to spare themselves and some 300 other officers and employes a similar indignity.

A fairy godmother stock option committee, consisting of the six highest-paid directors and officers voted to cancel options on 193,000 shares of Alcoa stock at $117.25 and to reissue options share for share at $68.50. This put all optionees (1) even with the current price of Aluminum stock and (b) 48¾ points up on the patient stockholders who held their shares without benefit of a fairy godmother committee to bail them out of their investment venture.

FOUR OF SIX BENEFIT

Four of the six members of Alcoa's option committee were direct beneficiaries of their own decision—Frank L. Magee, Alcoa president, had 5,000 shares under the $117.25 option; Ralph V. Davies, vice president, 1,000 shares; M. M. Anderson, vice president, 2,000 shares; Leon E. Hickman, vice president and general counsel, 2,500 shares. The nearly $50 per share cut in the price will save the quadrumvirate a half million dollars in cash if they take up the options, which have 10 years to run. The other members of the committee were I. W. Wilson, Alcoa chairman and chief executive officer, and Roy A. Hunt, chairman of the executive committee.

Of the 193,000 shares reoptioned, 27,000 went to officers and directors. Thus, of the total saving of $9 million to optionees, $1,300,000 went to the top. The option committee felt that because of the drop in the price of the stock the options would "fail to serve their intended purpose" as an incentive to executives and other employes.

AN ACCOMPLISHED FACT

Eventually, this cut in price, this $9 million, comes out of the Alcoa treasury, out of the shareholders. So some rugged stockholders might not accept the psychology behind the committee's action. They could argue that the drop in the price ought to act as an additional spur. The optionees ought to feel honor- and purse-bound to work harder and more imaginatively to make their options profitably exercisable.

The repricing of Alcoa options is disclosed as an accomplished fact in the company's proxy letter notifying stockholders of the annual meeting on April 17 at the Penn-Sheraton Hotel in Pittsburgh. Stockholders approval is not needed. The option plan, originally voted by shareholders in 1952, empowered the committee to make changes in the plan from time to time. Other companies, such as National Lead, which have not had shareholder authorization for unilateral option changes, are now seeking such authority.

To date, Alcoa executives and key men—the persons mainly responsible for the management, growth, and protection of the company's business—have been well served by the plan. They have had options to buy 1,057,600 shares at $17.69 a share. Aggregate indicated profit on those shares at today's prices would exceed $50 million. They have had options on another 174,700 shares at $29.37, on which the indicated profit would approach $6,750,000. Most of those shares have already been taken up.

OVERPRIVILEGED CLASS

In my recent book, "The American Stockholder," I made this observation: "Executives have become an overprivileged class in a democratic society. Their power to overpay themselves, with legal sanction, could, if unchecked, erode the very structure on which they and their corporations depend for survival * * *. Corporate power could become synonymous with grab-bag morality." The Alcoa reoption plan does not encourage me to alter that observation.

No wonder the foresighted modern college graduate aspires to batten down his future with a job in a modern corporation. If he succeeds in become a boss or near-boss, he will be able to reward himself handsomely with five- and six-figure

salaries, pensions, and stock options. That's why it's so hard to attract brilliant, intelligent youngsters into Government, teaching, and scientific research.

The pull toward industrial rewards is close to irresistible for those who like expense accounts, Cadillacs, and the rich, material life.

[From the New York Journal-American, Apr. 6, 1960]

DIRECTOR'S RESPONSIBILITY—TWO SCHOOLS OF THOUGHT ON ONE BOARD

(By Leslie Gould, financial editor)

Capital Airlines is in such serious financial difficulties that it is seeking a $12.9 million Federal subsidy.

The stock, which traded as high as $41.50 4 years ago, recently sold down to $8.62½. It closed last night on the stock exchange at $8.75.

A lawyer-director of the airline, who also had stock options, sold out two-thirds of this share holdings before a sharp drop in the market. He thus was able to buy back his stock and quadruple his former shareholdings at substantially lower prices.

As a result of his greatly increased holdings—now 80,532 shares—the largest single shareholding—he is seeking to be elected board chairman and chief executive officer after the annual stockholders' meeting April 20.

MORE THAN HALF-MILLION LEGAL FEES

He is Charles H. Murchison, a director since 1947.

His Washington and Jacksonville law firm has received in legal fees from the company $588,500.06 in the last 6 years.

The legal fees are more than twice the company's total net earnings for those years. The company made $211,041 in the 6 years, but this includes a $4,000,328 profit from sale of aircraft.

In addition to his firm's legal fees as company counsel, he received director's fees and in several years got a salary as chairman of the company's executive committee.

So, related to operating profits, it has been better to be the company's lawyer and board member with inside knowledge as to company affairs than a public shareowner.

LIQUIDATED 14,500 SHARES

After building up his stock holdings to 22,632 shares, including 7,500 shares bought under an option at $5.50 a share, Mr. Murchison started selling in 1956. This was right after the stock made its high of $41.50.

He sold from April 1956 to February 1957 a total of 14,500 shares. This reduced his holding to 8,132 shares. Taking the mean price—the average of the high and low and the number of shares liquidated each month—he got around $29 a share for his stock. The total amount received was around $419,325.

In September of 1957, when the stock had broken to $14.50 he started rebuying. He also bought stock in October, when it got down to $10.12½. He carried on his purchases through 1958 and into 1959, his last recorded purchase being in March.

COST NOW AROUND $16

In that period he accumulated 72,400 shares. The range in that period was from $10.12½ to $23.50. Based on the mean price each month, his cost for his new stock was around $16.25, against the approximate $29 at which he sold out in 1956 and 1957.

The cost of his present entire holdings, figuring in the $5.50 price for the option stock which he didn't sell, runs a little less than $16 a share.

In some ways, Mr. Murchison has outsmarted himself. He had a handsome profit on the stock he sold at the much higher levels, but in his ambitions to be boss of the airline he bought too soon. He has roughly on paper a loss of $7 a share on the stock he bought in the last couple of years—72,400 shares—or slightly over half a million dollars. This is offset a little by his profit on the $5.50 option stock.

DIRECTOR'S DEALING LISTED

The following tables show Mr. Murchison's activity in the stock, as reported to the SEC. The month the purchases were made, the amount bought, the monthly range and the mean price are given. The first table covers his sales, the second, his purchases.

Sales

	Shares sold	Price range	Average price
1956—April	400	38 -34¼	36¼
May	5,600	37¼-30⅛	33¾
September	1,000	31⅛-24⅛	28
October	4,000	26⅜-23⅛	25⅛
November	1,000	27⅛-24⅛	26
December	1,500	25⅛-23½	24⅛
1957—January	500	26¼-22¼	24¼
February	500	23⅜-20⅜	22¼
Total	14,500		

Purchases

	Shares purchased	Price range	Average price
1957—September	2,000	17¼-14⅜	15⅞
October	500	14⅜-10¼	12¼
1958—January	2,500	16⅜-10⅜	13⅜
February	10,000	18¼-15⅜	16⅞
March	23,000	17⅜-15⅜	16¼
April	3,200	16¼-14	15⅛
May	1,600	15⅞-13⅞	14⅜
June	10,400	16¼-15	15⅛
July	3,700	16⅛-14⅜	15⅛
August	3,000	17⅛-15⅜	16⅛
September	3,000	17⅛-15⅛	16⅛
October	4,000	17⅛-15¼	16⅛
November	100	17¼-16	16⅛
December	3,000	19⅛-10⅜	15⅛
1959—January	1,000	23⅛-18⅜	20⅜
February	1,000	22½-20	21⅛
March	400	23 -20⅜	21⅞
Total	72,400		

In contrast to Mr. Murchison, another director and present chairman, George R. Hann, of Pittsburgh, has never taken advantage of his inside information as to the company's affairs. Four years ago he held 45,882 shares. The company's just issued proxy statement shows the same holdings, 45,882. Mr. Hann has been a director since 1939.

Here are two schools of thought on directors and their responsibility to shareowners.

(Whereupon, at 1:15 p.m., the committee recessed, to reconvene at 10 a.m. Friday, July 21, 1961.)

STOCK OPTIONS

FRIDAY, JULY 21, 1961

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2221, New Senate Office Building, Senator Harry Flood Byrd (chairman) presiding.

Present: Senators Byrd, Douglas, Gore, Carlson, Bennett, and Curtis.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

The first witness is Mr. J. A. Livingston, of the Financial Bulletin, Philadelphia, Pa.

Will you take a seat, sir, and proceed?

I want to say, sir, that I read your column most every day.

STATEMENT OF J. A. LIVINGSTON, FINANCIAL EDITOR OF THE PHILADELPHIA BULLETIN

Mr. LIVINGSTON. Thank you very much.

Mr. Chairman and members of the Senate Finance Committee and audience, as I see it there are two basic objections to executive stock options.

The first objection is that they are self-serving. They are created by management for management, and an approval by the majority of the company's shareholders is not a genuine safeguard against this self-servingness.

Shareholders are inclined to go along with whatever management suggests so long as earnings and dividends are satisfactory.

If investment trusts or banks actively studied these plans and set up criteria by which to evaluate their fairness, this point might be invalid. But institutional investors are as prone to go along with management as the uninformed investor. As a result, there is no arms'-length bargaining between the management and the optionee, because the management and the optionee are the same person.

There is no outside conscience or judgment to determine whether these plans are fair to the stockholders or the taxpayers or the public at large.

The self-serving character of stock option plans is clearly indicated by the recent trend toward lowering option prices when a company's stock goes down, or I should say not whenever, but frequently, when a company's stock goes down.

The original excuse for the option was incentive. Prospective stock ownership would impel management to work harder, and, hence, boost sales and earnings and the price of the stock.

Now, when the stock goes down, the management votes itself stock at an even more advantageous price at which to purchase the stock than originally.

Thus you can argue that it is to management's advantage to see the price of the stock go down. In that way the stock costs the executive less money and the potential profit, once it goes up, would be proportionately greater.

You get an almost complete reversal of the stock option argument. You could argue that the stock option today, with the right to lower the price, is a disincentive. I realize that this does not fit in with present thinking, but it could over time so develop.

Senator GORE. Mr. Chairman, could I ask a question?

The CHAIRMAN. Senator Gore.

Senator GORE. Mr. Livingston, though it may not fit in precisely with what you have just said, I have had several instances cited to me, which I have not had the opportunity to verify, where the welfare of a corporation has been adversely and severely affected because the management, with the number that fell in a particular age group, would so manipulate the affairs of the corporation so as to, in one instance buy stock at a low level, and then maximize the value of the stock at the time when they wished to cash out.

I have had instances cited in which the advertising budget, for instance, would be cut to the core for the last 2 or 3 years before management expected to cash in their option stock.

Now, this would, in one way, increase short-run earnings.

I have had instances cited in which research and development was cut to the bone in the few years prior to the time when the controlling element in management expected to sell their option stock.

This, too, and a combination of these and other circumstances, can maximize the dividends, show a good profit and loss statement, run up the price of the stock, but thereafter the corporation might fall flat on its face.

So this which you say is theoretically possible, in numerous instances cited to me, has been effectuated.

As I say, I have not the staff to authenticate these facts, but this information has been given to me by corporation executives, by members of the boards of directors who disagreed with the policy but found themselves in the minority.

I thought you would pardon me for interrupting your statement to cite this.

Mr. LIVINGSTON. I have no positive evidence on this point, Senator Gore. But it is certainly within the range of human nature to think this might happen. Damon Runyon once said that where human beings are concerned, the odds are nine to five against.

And I think the possibility of manipulating stock in the market advantageously and manipulating stock options to be self-serving is not outside the bounds of possibilities.

I don't think, however, that that is the fundamental objection to the stock option plan.

Senator GORE. I agree with you.

Mr. LIVINGSTON. My second basic argument against stock options is that they create a tax-sheltered elite. Schoolteachers, professors, government officials, factory workers, union leaders, office employees, and even most newspapermen, such as I, don't have a way of escaping high income taxes through risk free capital gains. Nor do doctors, lawyers, or most other professional persons.

It seems to me that if income taxes are too high in the upper brackets that rates ought to be lowered, and special escape hatches not made available to special classes of people so that they can create their own manner of tax avoidance.

Senator CARLSON. Reading from your statement:

> The original excuse for the option was incentive. Prospective stock ownership would impel management to work harder, and thus boost sales and earnings and the price of the stock.

Is it your thought that the day is past when we should have stock incentive, or should we never have had it?

Mr. LIVINGSTON. I think we should never have had it. I think there is no point in giving it to the executives of companies, who have so many benefits, who have demonstrated that they have the capacity to work hard—the very fact that they rose to the top indicates that they have plenty of incentive. And this is just an added on emolument, an added on bit of gravy that I don't think they need.

I think I go into that a little later in somewhat more elegant language.

Senator CARLSON. I just wondered if you thought there was a time, maybe, when we should have had stock option incentives, and that that day was past.

Mr. LIVINGSTON. No, sir; I think it was a mistake to give them tax exemption privileges originally.

Senator CARLSON. Yesterday I mentioned the Ford Motor Co., and I made the remark that they did not exercise stock options, which is not correct. Henry Ford himself, I understand, based on a statement in the Harvard Business Review of July–August of 1961, says in his article, "I do not and I will not hold any options on the stock of our company," speaking himself.

Mr. LIVINGSTON. He doesn't need them.

Senator CARLSON. Regardless of whether he does or not—in this article it is an interesting statement, and I bring it up because of your own statement.

It reads this way:

> During the early postwar years at Ford Motor Co. a dozen or so skilled men, executives brought in from the outside after the war transformed a bogged down, antiquated, money-losing company into a modern, efficient, profitmaking enterprise, capable of meeting the toughest kind of competition and improving its position and renewing its own management resources.

Just a little lower in that statement:

> They joined the Ford Motor Co. largely upon my promise that I would do my best to give them an opportunity to acquire a stake in the company as soon as it was feasible to do so.

Is it your thought that this stock option that they did receive probably did not work to the advantage of the company?

Mr. LIVINGSTON. I think that the management team that Mr. Ford brought in certainly did reinstitute a company that was declining in

competitive relationship to both General Motors and Chrysler. Whether these men came in because of stock options, or whether they could have been brought in by some other means, I don't know.

I think that the stock-option device to get them in was useful to Mr. Ford, but I don't think it is desirable for Mr. Ford or for any other company to have that way of enticing executives. I think it is wrong; I think it is prejudicial to the large mass of taxpayers.

I think if Mr. Ford wanted to give these men a stake in the company he could have given them some of his own stock, and then they would have had to pay regular taxes on it.

There are any number of ways to induce people to go into a company. And I don't think we should use the Government tax loopholes or tax escape hatches for this purpose.

Senator CARLSON. That is all.

Mr. LIVINGSTON. Shall I continue, sir?

The CHAIRMAN. Yes, sir.

Mr. LIVINGSTON. The two main arguments, as I see it, for stock options, the two main arguments in favor of them are these:

One—and this comes back to what Senator Carlson suggested—they enable companies to hold onto men of talent who might otherwise go out and form their own companies, or to take jobs with companies that have stock options.

What I don't see as a particularly valid point is to say it will enable corporations to keep executives from going out and forming their own companies if one of our principal concerns, as so frequently enunciated, is to help the building up of small companies, letting them grow in order to increase competition. In other words, we say on the one hand we want to hold the men who would then become the competitors of the large corporation.

It is also argued that it enables the small companies to attract men from the large companies because the small companies can then issue stock options.

But, of course, if the large companies are issuing stock options and the small companies are issuing stock options, who is going to win in this game of giving the most away?

It seems to me that with stock options the rationale runs whichever way you want to argue it.

Now, some executives—and I think this is the point to which Senator Gore was alluding—actually don't approve of stock options, but say they have to have them in order to hold their best men against the piracy of companies which do grant stock options freely.

It seems to me that here we have a case in which good practice, which is paying an executive what he is worth in honest cash, is driven out by bad practices, granting an executive a stock market speculation.

Senator GORE. And Congress and the Government is party to this, because they make provision for tax avoidance.

Mr. LIVINGSTON. That is right. I don't think there would be nearly the number of stock options granted if there wasn't this tax immunity, tax avoidance, this capital gains. In other words, if profits on gains obtained through the granting of stock options were made subject to normal income taxes, I think that the stock-option plans would disappear very rapidly.

I think the stock option works like Gresham's law. A bad stock option drives out so-called good money.

Senator GORE. Not only does it provide that the income can be taxed as capital gains, but the law specifically provides that there shall be, for tax purposes, no income at the time the option is exercised.

Now, if I have an option to buy shares at $1,000, and I exercise that option on the day that those same shares are worth $2,000, do I not have a clear gain, a profit, an income of $1,000?

Mr. LIVINGSTON. Yes; indeed, you do.

Senator GORE. But the law provides that, for restricted stock options, there shall be no gain for tax purposes until such time as that stock is sold.

The corporation official who may be so fortunate as to be able to exercise his option without sale of any part of the option stock can let this stock pass into his estate and thereby avoid paying any tax at any time. Is that your understanding?

Mr. LIVINGSTON. Well, I am not an expert on the tax laws as they apply to inheritance, but I know that you do not have to pay a tax until you actually realize the profit by the sale of the stock which you have received under option; that is correct.

Senator GORE. It is true that estate and inheritance tax laws apply, but they do not apply while a man lives. So throughout the lifetime of an individual he would not pay any taxes on this income, which, in some instances, amounts to huge fortunes.

Mr. LIVINGSTON. That is right.

Well, you can, of course—you can make a rough computation of the value of a stock option at the time it is received, because there are "put and call" brokers who sell options to buy stock. And they have a cash market; you can look them up in any of the newspapers in which they are advertised. And for a 3-months' option to buy a stock you sometimes have to pay a price of $400 or $500 per 100 shares.

Senator GORE. Do you have evidence at hand, Mr. Livingston, of "put and call" operations on the part of those who hold restricted stock options?

Mr. LIVINGSTON. No; I don't. But I would think that this would be one profitable way of making money on stock options. Investment trusts, or any large investors have a right to sell a "put or call"—I get confused on this now. If he wants to get rid of stock, he can agree to give somebody a call on it at a particular price, and he gets paid for it. So it would seem reasonable that this would happen, but I don't have any evidence of it.

Senator GORE. I have been concerned with the growing attitude, on the part of our citizenry, that our tax laws are discriminatory, that they are unfair. I expressed the view yesterday that, despite the imperfections of our system, we had the most efficient, the best enforced, perhaps even the most equitable tax law of any nation in the world.

Without this, it would be utterly impossible for our country to play the role which is now its burden and glory. But if we continue provisions in the law, which are unfair and discriminatory, I think we run the risk of bringing our whole tax program into contempt on the part of our people. And that would be a very serious blow to our society.

Mr. LIVINGSTON. I couldn't agree with you more heartily, Senator. It sounds as if we are kind of kicking the ball back and forth. But in my book, "The American Stockholder," I wrote that executives had become an overprivileged class in the democratic society, and their

power to overpay themselves with legal sanction could, if unchecked, erode the very structure on which they and their corporations depend for survival.

And I think the way our tax laws are set up, to permit this type of loophole by stock options, is a form of discrimination.

I do have to add, however, that all taxes are discriminatory in the sense that whoever pays them feels discriminated against.

I think that we are always concerned with in the tax structure is not that the laws are discriminatory, but to see that in some instances they are not too glaringly discriminatory.

Senator GORE. I don't know that I could entirely agree with you that those who pay taxes feel that they are discriminated against, so long as the taxpayer feels that other taxpayers are bearing a proportionate share of the burden, though he would prefer not to pay his taxes, I don't feel that he feels he is discriminated against.

Mr. LIVINGSTON. I will accept that.

Senator GORE. Let me cite an instance that I have previously cited in a speech before the Senate, of a very fine man. I intended no criticism of him then, and I intend none now. He is a fine, public-spirited man. I am referring to Mr. Watson, the president of IBM. He has, by reason of stock options, had an opportunity to accumulate income, profits from restricted stock options, of some $4½ million. I am informed that he has sold none of them. I have reason to believe that he has no intention of doing so.

This is a $4½-million gain on which he has paid no taxes, on which, if he does let it go into his estate, he will never pay taxes.

Meanwhile, every man who works at a wage or on a salary, every farmer who tills the soil and earns a meager amount, must pay and pay regularly.

Now, this is the kind of thing that causes people to rebel at paying taxes, to resent the payment of taxes, to feel that their Government is not being fair.

Would you agree with that?

Mr. LIVINGTON. I do agree. And I would further add that I hardly think that Mr. Watson needs a stock option in International Business Machines to create incentive for him.

He has plenty of incentive anyway. He already has a very large amount of stock that he got from his father, and his mother has a large interest in it. So the incentive argument in his case is totally invalid.

Senator GORE. I know you mean no criticism by referring to this family, I do not either. I think, if my memory is correct, that they own some $15 million worth of stock in the company and, in addition, Mr. Watson receives a salary of $300,000.

One must wonder what additional incentives are needed. It becomes ludicrous to refer to stock options as an incentive in this case.

Mr. LIVINGSTON. The rationale of that, Senator, is this: The corporate structure is heirarchical, and if you want to issue stock options to those below, you have got to do it on a pyramidal scale. And, therefore, the man at the top has to get the very highest number of shares as a stock option, because not to give it to him would be unfair. So you can't issue a stock option to those below unless you reward the men at the top.

I happen not to agree with the argument; I am simply indicating what the argument is, or what the rationalization is. I think rationalization runs through this whole area.

Well, I am intemperate when I think about the plan, because I think it is unfair.

Senator GORE. Well, if you are intemperate, what do you think about a man with four or five children at home who must pay taxes every Friday afternoon on his weekly paycheck, and who sees men accumulating vast fortunes and paying no taxes at all?

Mr. LIVINGSTON. I don't have to think about the man with five children; I just think about myself.

Senator GORE. Well, I suppose he does, too, and I do, too. And when we think about ourselves, the next step is to compare ourselves with other taxpayers. I am dedicated to the view that every citizen with an income above the subsistence level should make some contribution by way of taxes to his Government, and that when we apply the progressive income tax formula, a man must pay according to his ability to pay.

These gimmicks which the Congress has written into the law, knowing that they were creating gimmicks for tax avoidance, are utterly inexcusable to me.

Mr. LIVINGSTON. Shall I go on, sir?

Senator GORE. I will desist.

Mr. LIVINGSTON. No, I agree with you, I didn't mean it that way, I am sorry.

Senator GORE. And we are having a good time, aren't we?

Incidentally, I quoted from one of your books on the floor of the Senate.

Mr. LIVINGSTON. I know you did, and I must thank you.

Senator GORE. I must tell you that on one other occasion——

Mr. LIVINGSTON. I know, I called you irresponsible.

Senator GORE. So a lot depends on the point of view.

Mr. LIVINGSTON. The second principal argument for the stock option plan is that it enables the executive to acquire stock in the company he works for, that this gives him a proprietary interest in improving the company.

But it seems to me that he could acquire this proprietary interest by buying stock in the open market just as other persons do, and then he would be risking his own hard cash instead of being granted a free ride at the taxpayers' expense and the stockholders' expense.

After all, if an executive uses his own money to buy stock, that indicates he really has faith in himself, and in his company, whereas the stock option is simply an attempt to have the stock but to take no risk whatsoever. It is a heads-I-win, tails-I-can't-possibly-lose operation.

Furthermore—and this goes back to a point that Senator Gore made—stock options can be a distraction to executives. The executives have an opportunity to buy much more stock than they could possibly afford to buy with their own money. And often they borrow to take up stock options.

And so because they are in debt, they could become more interested in the rise and fall of their fortune in the stock market than in the prudent and intelligent operation of their company.

I think it was George Larimer who said he had to sell some American Motors stock in order to pay off the debt he had in acquiring this stock.

Finally, it seems to me that the stock option is an affront to honest executives. It implies that they need some special incentive over and above that required by professors and schoolteachers and lawyers and other workers to do a good job.

It seems to me—and I mentioned this earier—that most men who rise to the top in companies have a streak of perfectionism in them, a desire to do a superlative job for its own sake.

The argument that good men must get a free ride in Wall Street as an incentive to work derogates the very quality they have demonstrated in becoming executives. I conclude by asking this question: When it comes to executive compensation, what is wrong with money?

And if taxes are so high that they make money no good, then we had better do something about tax rates. And then we would be able to worry less about tax-avoidance gimmicks.

The CHAIRMAN. Thank you, Mr. Livingston.

Any questions?

Thank you very much indeed.

The next witness is Dr. Roger Murray, of the Columbia University Business School.

Will you take a seat, sir, and proceed.

STATEMENT OF DR. ROGER MURRAY, COLUMBIA UNIVERSITY BUSINESS SCHOOL

Dr. MURRAY. Mr. Chairman, and gentlemen, my name is Roger F. Murray. I am the S. Sloan Colt professor of banking and finance of the Graduate School of Business of Columbia University. I teach primarily in the fields of corporate financial policy and investments.

One of the basic resources of our economy is that factor which we normally describe as "managerial skill," or simply as "management."

And, as the years take their toll of managerial skills, we have a problem of replacing them, and of expanding this reservoir.

In the graduate school of business at Columbia, we are training young men to become effective managers in a wide range of different types of business. Our school and other schools of business can train men and help them to develop their skills. We can launch them into the business world with a good understanding of business in general, and with special skills in functional fields of business.

But it is up to their employers to provide the other ingredients of experience and drive.

In any organization, whether it be a private business, a unit of government, or a university faculty, we always find that some members of the group show outstanding initiative, imagination, and drive. These are the men who become the business leaders, the U.S. Senators, and the most respected professors.

But, unhappily, there never seems to be enough of them. We could always use more.

Now, there are certainly many factors which are important in the development and stimulation of these qualities, of which compensation is only one.

In a profitmaking organization, however, it is only natural that money should bulk large in the arrangements for rewards and incentives. If we want a man to develop himself, to compete for the next higher job in the organization, we must convince him that the next higher job is worth his efforts.

One way this is accomplished in business is by the salary which the job commands. In a university we may emphasize professorial rank more than salary, but it is essentially the same idea of convincing a man that the risks and responsibilities of securing a promotion are indeed worth, not just his routine effort, but his very best effort.

This conception of the function of wage and salary administration at all levels of the organization might suggest that wages and salaries, group life insurance, accident and health coverage, and pension plans, comprise a complete and effective program for encouraging these qualities of initiative and drive. But experience has shown that the motivation of able individuals can be increased, if in addition to rewards for personal accomplishments there are rewards for contributing to group efforts.

Every member of a university faculty does a lot of work, not to enhance his individual reputation as a teacher and a scholar, but to enhance the standing and prestige of his university.

How can a business corporation bring home to its employees the fact that their interests as manager are closely identified with the objectives of their stockholders?

This problem has been discussed many times since 1932, when Adolph Berle and Gardner Means wrote their classic "The Modern Corporation and Private Property."

This book and the many which have followed describe the separation of ownership from management in our large public corporations.

The problem has been recognized in the form of this question: How can we induce management to give more consideration to the objectives of the owners?

This is not an easy problem, and many solutions have been offered over the years. Some people have a great deal of faith in profit sharing. Others prefer various kinds of incentive compensation, and still other observers believe that stock options are the best device yet developed to make more effective our system of salary incentives, and to bring home to people at all levels of management their relationship to the success of the enterprise as a whole.

No one has proved that any one of these methods of incentive compensations is better than all of the others in all circumstances. On the contrary, it is abundantly clear that circumstances differ in individual situations, and that the best results for the growth and efficiency of an enterprise vary from case to case. Because different individuals and different groups respond to different incentives, it is essential to have flexibility in any effective program of rewards and incentives.

The case for the stock option has been widely discussed.

The latest and one of the best discussions is in the July-August issue of the Harvard Business Review. This is the brief article by Henry Ford 2d, to which Senator Carlson made reference earlier this morning. It is entitled "Stock Options Are in the Public Interest."

As Senator Carlson said, Mr. Ford recites his problem at the end of World War II, when he had what he calls a "bogged-down, antiquated, money-losing company." He believes, Mr. Ford believes, and I certainly would agree, that the use of stock options was one of the most effective methods he had at his disposal in developing a new managerial group for a major American industrial enterprise.

But Mr. Ford's experience is by no means unique.

How can a new, small, speculative enterprise attract experienced, trained men away from the safety and security of employment with a large, well-established corporation?

Not by salary and fringe benefits for sure.

It seems to me that this can be done only by offering the men willing to assume the risk a real, tangible share of the rewards if the new enterprise succeeds.

Thus, stock options can be a factor in creating that mobility of managerial personnel which is vital to a dynamic and expanding industry.

But attracting new personnel is no more important, of course, than stimulating present employees, and it is in this area that the widest use of stock options is made.

As at matter of equity, and as a matter of necessity, our personal income tax structure must be progressive.

Some people hope that eventually there might be a general reduction in rates. But this depends on many unknown and unpredictable factors.

In the meantime, the problem of corporate management is how to make advancement as attractive as possible. The individual in middle management may face a marginal tax rate of 35 or 40 percent, or substantially more, on a salary increase which a promotion involves. This is obviously a lot less incentive to take on the new responsibilities than would be the case if the marginal rate were materially lower.

The maximum capital gain rate of 25 percent, for example, which might apply to a profitable stock option, means less watering down of the reward and incentive.

Although the granting of a stock option is no guarantee whatever that it will result in additional compensation, there is always that possibility, coupled with the assurance that there will be a ceiling on the highest applicable tax rate. The contingent nature of this form of additional compensation is, in fact, most apt to appeal to precisely the kind of risk-taking individual management is most anxious to spur on to greater effectiveness.

If stock options have an effective place in a company's compensation program, they are, of course, the most economical form of incentive from the standpoint of the stockholders, involving, as they do, no outlay of funds. Granting a key employee the right to buy stock in the future at a price fixed in the present involves a decision to raise new equity capital if the company prospers, and therefore additional capital is needed in the business.

It is true that an option, when exercised, results in realizing a lower price for the shares than would have been obtained by waiting to sell the stock. To this extent, the stockholders are sharing some of the gains from the success of the enterprise with those who presumably have contributed most to achieve that success. This is both the in-

centive and the reward. And it is much more economical to the stockholder than a salary increase or a bonus.

Senator GORE. May I ask a question right there?

The CHAIRMAN. Senator Gore.

Senator GORE. You have just said, Professor, that at this point, when the option is exercised, the official, the holder of the restricted option, shares in the gain of the company, and then you just said that this was both his incentive and his reward.

Am I correctly quoting you?

Dr. MURRAY. That is correct.

Senator GORE. Then at this point, when this citizen has a gain, has a reward, should he not at this point be subject, as other citizens are, to the payment of taxes on his gain?

Dr. MURRAY. If he realizes the gain, it seems to me he should be subjected to the same tax as any other investor would pay on the realization of his gain.

Senator GORE. But that isn't the law.

Dr. MURRAY. An individual who had owned the stock during that period and sold it would pay at a capital gain rate. And there is what the——

Senator GORE. And there is compensation for his services. This is substantial—you say, and I agree with you, that he should pay his taxes as other citizens do, at the time he receives his compensation.

Dr. MURRAY. If he realizes a gain on his investment in the company. And this is what he has made, an investment in the company.

Senator GORE. Now, you are shifting the scene to investment. You started out saying that this was given to him as an incentive to give greater service to the company, to share in its gain, and you had just arrived at the point when you said that his compensation was now realized, that he was sharing in the gains of the company, that he had received his reward.

I take it, reward is compensation.

And you say that at this point he should then pay his taxes.

But the law exempts him from taxes at this point.

Do you support or do you defend that provision of the law?

Dr. MURRAY. Sir, when he exercises his option he makes an investment, he buys shares of the company, just as you or I might buy shares of the company.

Senator GORE. All right, let's analyze that.

You are now into the second phase.

But let's not leave the first phase.

The whole burden of your testimony is that the official should be paid well; he should be given incentives to render good, dedicated service; is that not right?

Dr. MURRAY. Yes, sir.

Senator GORE. And that the most effective way of providing this reward, this incentive, and this compensation for dedicated service is the granting of stock options?

Dr. MURRAY. In my opinion, that is one of the effective ways.

Senator GORE. All right. Say this official has an option to buy stock for $1 million. The company has prospered. The price of the stock

has risen. Until the day upon which he exercises the option, the stock which he is privileged to buy as incentive, as reward, as compensation, at $1 million, has a market value of $2 million. He has then realized a reward; he has then been compensated to the extent of $1 million. And, as I understand you, you say that he should then pay taxes as other citizens.

Dr. MURRAY. If he realizes the gain, as any investor must pay a tax if he realizes the gain.

Senator GORE. I am not speaking of an investor. I am speaking of the privilege, the reward, as you described it.

Dr. MURRAY. Sir, might I explain——

Senator GORE. He is not an investor until he exercises his option, and at the time he exercises his option he has then received his reward, his compensation, to which you refer as incentive?

Dr. MURRAY. He has not realized it until he sells the shares. The stock may go right back down to a million dollars next year. If he hasn't sold it, he has received nothing.

Senator GORE. Do you seriously contend that if I sell you a share for $1 and that share is worth $2 that you haven't realized a benefit of $1?

Dr. MURRAY. Not unless I sell it and convert it into cash, I have not realized anything.

Senator GORE. Now, you know——

Dr. MURRAY. And I would have no tax liability.

Senator GORE. I always marvel—well, if you seriously think that, I won't ask anything else.

Senator BENNETT. May I get into this, Mr. Chairman?

Many people went broke in 1928 because they looked at the market before the October crash and decided they were rich. And then when the market crashed and they found out actually at what price they could sell their securities, they discovered they were bankrupt.

Now, it is not how much, what kind of a figure you put on a list opposite the value of your property that makes it worth that much; the test is at what price can you sell it. And under the capital-gains law, you are not required to pay capital gains every time the stock market goes up on a share of stock that you own; you only pay your capital gain when you actually achieve it. In some cases people who assume they have capital gains, looking at the stock market reports daily in the paper, find to their regret they have a loss when they get ready to sell. It is a very common story that you count your chickens before they are hatched.

And when you actually sell, or have to sell, you find yourself in serious difficulty.

The position of my friend from Tennessee reminds me of the famous story about the man who had the thousand dollar dog to sell. He had a dog, and he said he wasn't going to sell him unless he got a thousand dollars for him. Now, he had a valuable property. He met another friend the next day, and the fellow said, "Did you sell your dog?"

"Yes, sure."

"Well, did you get a thousand dollars for him?"

"Oh, yes, I took two $500 cats in trade."

Now, as I understand the argument of my friend from Tennessee, it is that if on a given day you look into the stock market report in the paper and it says, you have got $2 million worth of stock, that you then actually have it, and you should pay capital gains tax on it.

But looking at it tomorrow, this million dollars' worth of stock may be worth $800,000, and you may be more interested in finding out whether you can get a capital loss.

Senator GORE. If the Senator so understands me, he misunderstands me. I am not speaking of cats and dogs. I am speaking of compensation through transferrable instruments that have real, tangible value. It is not in any respect comparable to someone's imagination about a dog being worth a thousand dollars. If I sell you $1,000 worth of shares in IBM today, and at a price of $500, you have a tangible profit. You can convert it to cash on the same day at the same hour, and if I give it to you by way of compensation for services rendered, then the Supreme Court, in Justice Black's opinion, says this: "When assets are transferred by an employer to an employee to secure better services, they are plainly compensation."

Senator BENNETT. I am not quarreling with the fact that they are compensation, but my point is that you can't measure the value of the compensation until you test it by selling the stock.

Now, if you give me—and I would be very happy to make that deal with you, I would be glad to buy $1,000 worth of IBM, or receive $1,000 for $500——

Senator GORE. Will you be willing to pay an income tax on it.

Senator BENNETT. If I sell it that way and make $500 profit, I would include it in my income tax.

But——

Senator GORE. Wait just a minute. This is an interesting point. If I give it to you by way of compensation, I have then compensated you $500 for services rendered. Why should you want to postpone the payment of taxes on that, or why should you be justified—why should the Congress permit you to postpone your tax liability any more than if I wrote you a check of $500 for services rendered?

Senator BENNETT. Because the check is worth $500. Presumably I can take such check down to a bank and get $500.

Senator GORE. You can take the stock, too.

Senator BENNETT. But when you give me the stock, you give me actually more than you do if you give me $500 in cash, you give me the option, you give me the right—I won't use the word "option"—the opportunity to hold that stock. I can hold the check for a year, and all I will get out of the check is $500, and a lot of angry letters from the bank asking me, why don't you cash the check so the record can be complete.

But if you give me the stock, you give me the right of holding that for a length of time to take a risk with it, the possibility that it may be worth more than $500, or less depending on the rise and fall of the market.

Senator GORE. You must stand on risk on my check.

Senator BENNETT. Well, far be it from me to suggest that your checks are not good.

Senator GORE. This is not exactly a confession.

Senator BENNETT. No, I am sure it isn't.

When you give me the stock you give me something that might be said to have a value that cannot be completely measured. And I decide that if I want to hold it, I may get more for what you have given me, and also I run the risk of getting less.

Therefore, it seems to me that it is reasonable to apply the tax at the time I have actually determined whether my risk was a good one or a bad one.

Senator GORE. Well, if I may respectfully suggest it, you are confusing compensation with investment. The role of an investor is one thing, and the role of an employee's compensation is something else.

Now, when I employ you—and I would be very happy to employ you if I had the privilege—and your compensation is to be $500 and I give you either a check or stock values with current, available, negotiable value of an equal amount, then you have been compensated $500.

According to the Supreme Court, this is compensation in either event.

And tax liability should, in my opinion, accrue.

But, by reason of this gimmick in the tax law, the tax liability is postponed, deferred. And no tax may ever be paid. The stock might never be sold.

Senator BENNETT. I wonder if this isn't inherent in the nature of the stock which you give me as compensation. You give it to me on Friday, and the stock exchange is closed, and I can't cash it until Monday, I may automatically have an increase, even though I desired to cash it as quickly as possible. The very nature of the one, the check, is that it relates to money which has a fixed value.

The stock is a share in an enterprise, and that value can vary from day to day, it does on the big board, and maybe even with the best of intentions, before I could get down and trade that stock I would have a profit or loss in it.

Senator GORE. That is almost as imaginary as the dog and the cat.

We are speaking of transferable instruments with tangible values. We are speaking of compensation to corporate employees.

That is what you were talking about, wasn't it, Professor?

Dr. MURRAY. Could I explain precisely the compensation and the investment to clarify my earlier statement?

I believe that I could clear up, perhaps, one point in connection with this if I had the opportunity to give an explanation.

Senator GORE. You shall have whatever opportunity you desire, Professor.

I would like first, if you do not mind, to ask you if at this point you were not speaking of the compensation, incentive or rewards given to corporate employees.

Dr. MURRAY. I was, sir. I was not sufficiently specific in defining the terms, which is precisely what I would like to do now.

Senator GORE. You shall have the privilege.

Dr. MURRAY. Thank you, sir.

As of today, if I am working for you, you are my employer, you collectively as a board of directors, on this day I can go out in the market and buy stock in our company, or you can say to me, "Professor Murray, we will give you a right to buy stock at any time at approximately today's market price."

Senator GORE. Let's put a figure, say 100.

Dr. MURRAY. Let's say 100, the stock is selling at 100, and you say, "Professor Murray, if you will continue to work for me and behave yourself and do your job, you may buy these same shares that you can buy on the market at $100 at any time from the company for $100 a share."

Senator GORE. Now, at this point you make no investment, do you?

Dr. MURRAY. I have made no investment.

Senator GORE. You have assumed no risk.

Dr. MURRAY. Instead of my going out and making the investment on that day in order to own some shares in the company, I have been granted the right to postpone the date of the investment. And this, of course, is of value to me.

Senator GORE. You have not only been given that right, you have also been given the choice as to whether you will postpone it or whether you will decline it, isn't that right?

Dr. MURRAY. That is correct.

Senator GORE. And what does it cost you?

Dr. MURRAY. It costs me my best efforts to the enterprise in the future.

Senator GORE. At this point, when I, your employer, grant to you, my employee, this privilege, which at some indefinite time you have the privilege of choosing to exercise, you have invested nothing?

Dr. MURRAY. That is correct.

Senator GORE. You have paid nothing for it. You have assumed no financial risk, is that correct?

Dr. MURRAY. That is correct.

Senator GORE. Now——

Dr. MURRAY. The only risk I have undertaken is my commitment to stay with this company and work for it real hard.

Senator GORE. That may or may not be a condition of the stock option.

Dr. MURRAY. In most cases, of course, it is. In most enterprises, it is a real condition.

Senator BENNETT. Professor Murray, even if it is not a contractual condition, it has the effect on you of making you feel that you want to stay, even though you make no promise to him?

Dr. MURRAY. That is absolutely right, my good standing and my reputation is committed.

Senator GORE. As a sidelight to that, many of the options, Professor, the record shows, have been granted just before retirement. So I am perfectly willing to take a hypothetical case, which you wish to take, but we must understand what the case is.

Now you have taken yourself as a hypothetical employee.

Dr. MURRAY. That is right.

Senator GORE. I, as your employer. And I have conferred upon you the privilege of exercising an option or not exercising an option.

Dr. MURRAY. That is right.

Senator GORE. At some later date, but indefinite date to purchase stock in the company at, I believe you said, $100.

Dr. MURRAY. Yes. What you have given me is this flexibility as to time.

Senator GORE. Now, why have I——

Dr. MURRAY. You have given me a fixed price at which I can acquire the stock.

And if I don't have this in order to buy the stock, I may have to pay $105 next week, I may be able to buy it for $95, that is fine, but I may have to pay $105 or $120.

Senator GORE. You say I have given you something, I have given you an option, that is what it is. It is restricted to you, and a few more like you.

Dr. MURRAY. That is right.

Senator GORE. And you have paid nothing for it.

Dr. MURRAY. That is right.

Senator GORE. You have no capital risk involved.

Dr. MURRAY. That is right.

Senator GORE. Now, go to your next step.

Dr. MURRAY. Now, what is this worth to me?

This is the privilege of making an investment at a price fixed at a time of my own choosing. The answer is, nobody knows on the date of granting the option whether this is going to be worth anything or not. If the company succeeds and it grows and it flourishes—and perhaps I have been able to contribute something to this performance—then it is going to be of importance for me to have had this right to purchase the stock at this later date at a fixed price.

Senator GORE. And this is to be a part, and is a part, of your reward as my employee?

Dr. MURRAY. That is correct.

Now, how big is the reward?

The reward is that when I realize, or if I realize on that stock, and I sit down and compute my gain——

Senator GORE. Now, you are entirely missing the step——

Dr. MURRAY. And pay my tax——

Senator GORE. You are entirely missing a step, Professor. Let's come to the point where you exercise your option, let's not leap over that.

Dr. MURRAY. All right, when I exercise my option, I have not realized anything. I have made an investment, I own a certain number of shares at $100 a share.

This is the only fact that has been finally and conclusively determined.

Senator GORE. You just said to me a few moments ago that this right which you had the privilege of exercising was a part of your reward as my employee.

Dr. MURRAY. Yes.

Senator GORE. Now, you have come to the point of exercising that right, at which time you receive your reward, is that correct?

Dr. MURRAY. This is the time at which I have acquired——

Senator GORE. How can you have it without receiving it?

Dr. MURRAY. Until I sell the stock I have not realized my reward.

Senator GORE. Now, you in your own words said that this privilege which you had of exercising an option was a part of your reward as my employee.

Dr. MURRAY. That is right. We now have the problem of determining the amount of the reward, how much is the reward.

Senator GORE. At the time you exercise it?

Dr. MURRAY. How much is my reward.

Senator GORE. At the time you receive it?

Dr. MURRAY. My reward is realized when I sell that stock, and that is when I pay my tax as any other investor does.

Senator GORE. You receive your reward, Professor—and not even a professor can avoid logic—at the time you exercise your option. Thereafter, you are an investor, but at the time you exercise your option, which in your own words was a part of your reward as my employee, you have received your reward, and, under the Supreme Court decision, this is compensation on which you would have tax liability.

But, by reason of this gimmick which the Congress so unwisely wrote into the law, this is artificially overlooked.

This tax liability is deferred.

Dr. MURRAY. Senator, may I elaborate on our illustration here?

On this same day you gave me that option, I had some money that I had saved up, and I bought 100 shares at $100 a share in the open market. On the day——

Senator GORE. Let's just understand this——

Dr. MURRAY. This I bought on my own.

Senator GORE. Yes, and there you were an investor.

Dr. MURRAY. Yes.

Senator GORE. In the other instance you are an employee, and you are being compensated, you are being given an option as a part of your reward, as a part of your compensation, as an employee. Insofar as the function of investment, this is something which you could do whether you were an employee or not.

Dr. MURRAY. Absolutely.

Now, on the day when I exercised my option—let's say it is 5 years later, the stock is selling at 150—I now have two blocks of stock, each of which cost me $100 a share. Each block of share is selling at $150. Do you contend, sir, that on the stock I bought outright that there is some kind of a tax payable if I don't sell it?

Senator GORE. No, that is not the law.

Dr. MURRAY. Certainly. And I have two blocks of stock, they each cost me $100 a share, and I haven't sold either block, I have realized no income in any definition of the tax law. If I sell my stock, whether it be my option stock or mine directly, I am prepared to pay the capital gains tax.

Senator GORE. Surely a professor in a school so renowned as yours is able to distinguish between the role of an employee and the reward he receives as an employee, and the role of an investor who purchases with his capital and takes the risk involved therewith.

Senator BENNETT. May I ask a question?

If on this mythical day when you are about to reward a faithful employee you decide to pay him cash, you are going to pay him $10,000 in cash as compensation, and the corporation then gets the tax benefit of 52 percent of that cash, because it is employees compensation which is taxable. But, if on that day they decide to give him an option to buy $10,000 worth of stock at the price ruling that day, the corporation is not allowed to deduct 52 percent of the value of that stock.

So you do not have an identical situation with respect to employee compensation.

In one case you are going to pay him cash, and in the other case you are going to give him a stock option.

There is another difference before you start.

Is that right, Professor Murray?

Dr. MURRAY. That is absolutely correct. What you are giving in the option form is the right to invest in the future at a price. It is always the right to invest and what the man acquires is an investment. The difference between the option on the stock and buying it in the market is the difference in price.

When he realizes on the sale of the stock, as you stated clearly, earlier, that is when the gain is realized, that is when a tax is clearly payable, as on the sale of any capital asset.

Senator BENNETT. This is the first time he knows the real value of the right he has been given, in terms of its ultimate compensation to him?

Dr. MURRAY. Sir, this is a lesson that I learned at the very start of my business experience, when I went to work in a bank, and they gave employees the opportunity to buy stock way below the market. You could buy it at $165 a share, and make regular payments out of your salary for it. The only trouble with this valuable option that was worth—the stock was worth $200 a share or more when you got it—was that by the time you paid for it the stock was worth $40 a share. This was a test of whether that option had been of value to you, what the stock was worth when you sold it.

Senator BENNETT. I was going to develop the same kind of approach with this example:

Suppose a faithful employee had been given a stock option in 1929, and had decided on the morning of that October day that the market had reached a point now where he was going to sell it, but by the time he could get off work or get to his broker, who was busy, he suddenly discovered that the stock was worth 10 percent of what it had been worth the night before when he had made his decision.

It seems to me that people who tend to argue about this as a gimmick always assume that all stocks go up.

And, unfortunately, I have learned, as you have, that many of them tend to go the other way.

Senator GORE. Before we go any further, Senator Bennett, the situation which you outline, of which you said you were not sure, is, I think, correct. If a corporation pays its employee a thousand dollars, or $10,000, in salary or bonus, that is an expense of doing business, and that is deductible.

If, instead of the corporation giving to its employee $10,000 in stock values——

Senator BENNETT. The option to purchase $10,000 in stock values.

Senator GORE. The option to purchase stock in a manner which gives to the employee a purchase price $10,000 less than the market value, then this is not deductible, and that illustrates one of the evils of this system which results in a watering down of the value of the stock of all stockholders in this particular corporation.

Doctor, I will not—it may not have been your purpose to draw a clear line of distinction between the role of an investor on the one hand and rewards and compensation of an employee on the other. But you have done it. So we will thank you, sir, and you may proceed.

Dr. MURRAY. Any device such as this needs regulation to assure its fair and equitable use.

Logically and in practice, this regulation is supplied for most public companies by the SEC. Proxy statements and annual reports provide the stockholders with complete information as a basis for their balloting on the stock option plan.

In my judgment, the question of the volume and terms of the options granted is the proper concern of stockholders, and present regulations place them in possession of the relevant facts, along with information about other elements in the compensation arrangements.

I am not in a position to speak for others, but on the point which Mr. Livingston made earlier this morning I know in the investment company of which I am a director we closely examine the terms of stock option plans before we vote on them. And it has not been unknown for us to obtain changes in stock option plans when we did not feel that they were fully in the stockholders' interest.

But, by and large, stockholders have approved stock option plans in large numbers, and for three principal reasons:

First, any company can afford liberal compensation of good management. Only inferior management is really expensive and stockholders know it.

Second, salary payments to management tend to be relatively fixed. Stock options require the achievement of results before they become a real form of compensation.

Third, key employees will be more effective if they have stock options as a constant reminder of the fact that they are hired not just to perform specific services, but to contribute to the long-range profitability of the enterprise.

It is this profit consciousness of key employees that stock options emphasize in a most economical way.

Now, it is easy to recognize that this is vitally important to the stockholders of an individual company. But all of us are interested in the profitability of business. Profits are the reward for risk taking which provides job opportunities, economic growth, and greater output.

Also, in our kind of a profit and loss economy, profits are the measure of efficiency—the efficiency of management in utilizing the resources which savers have made available to it. To say that we wish to encourage profit consciousness is merely to say that we favor the encouragement of the drive for efficiency and productivity in American industry.

With our freedom—with our system of individual freedom and initiative in crucial competition against totalitarian systems in the arena of world opinion, we should overlook no opportunity to reinforce this drive for efficiency and productivity.

Stock options, because they have made a modest contribution to this top priority of objective, deserve our encouragement.

As Mr. Ford has stated in the title of his article, stock options are in the public interest.

Thank you for your patience.

Senator GORE (presiding). Thank you.

Senator BENNETT. No questions.

Senator GORE. The next witness is Louis Ware.

STATEMENT OF LOUIS WARE, INTERNATIONAL MINERALS & CHEMICAL CORP.

Mr. WARE. Mr. Chairman and members of the committee, my name is Louis Ware. I am a mining engineer and corporation executive.

I shall speak as one who has been responsible for initiating in a corporation a plan of stock options; as one who has enjoyed the benefits of stock options——

Senator GORE. Are you referring now to restricted stock options?

Mr. WARE. Yes, that is the subject.

Senator GORE. Yes. But you said stock options. There are many kinds of stock options. The subject here is the restricted stock option.

Mr. WARE (continuing). And I have seen the utility of the stock option plan in building a capable team of management experts.

I graduated from the University of Kentucky, the School of Mining, in 1917. I began my career in the copper mines of Arizona. I worked there as mining engineer, chief engineer, miner, boss, foreman, general foreman, and superintendent of a large copper mine.

From there I went to South America, where I was general superintendent of mines in the nitrate fields of Chile.

Later I acted as consultant for a number of mining companies in New York, and testified as expert in mining litigation.

I also had 5 years of experience with a major bank in New York City, where I handled various mining and business assignments.

In 1934 I was appointed president of the United Electric Coal Co., in which a number of New York banks had large interests.

In 1939 I left that company to become president of my present company, which is the International Minerals & Chemical Corp.

In 1959 I became chairman of the board of directors, and I now occupy that position.

I have had broad experience in mining and business.

While in New York I studied banking and finance, and became familiar with the investment community and the securities markets.

In 1939, when I began with this company as its president, we had sales of somewhat less than $10 million. The company, although having been in existence 29 years, had never paid a dividend on its common shares, and had arrears of approximately $90 a share on its preferred stock.

I inaugurated a general long-term plan of expansion and growth which mainly consisted of the development of a large potash mine in New Mexico, expansion and improvement of our phosphate mining and phosphate chemical operation, the acquisition of other companies, and expansion in the chemical business.

Soon after this start, I successfully recapitalized our company, establishing a new common share and a preferred share on which dividends have been paid regularly ever since that beginning.

This company's sales have gone from that in 1939 of $10 million up to the present $130 million.

This year we will have profits of approximately $8 million.

We now have mining, chemical and mineral plants in 70 locations. Our head office is located in Skokie, Ill., a suburb of Chicago. And we have offices in a number of cities abroad.

I experienced firsthand the value of stock options. After there was a showing of success with this company in my hands, the fact that I was trained and experienced in mining, there were a number of mining companies needing presidents, and many offers were made to me. About that time in 1951 we started our stock option plan, and I was one of the first to obtain an option.

I refer of course in all my talk here, Senator Gore, to the restricted stock option.

This stock option contributed much——

Senator Gore. May I inquire there? At that time how many others received this privilege?

Mr. Ware. I cannot tell you how many. But I would say there were probably 25, it was the top, key team in the company.

Senator Gore. And how many employees did your company have at that time?

Mr. Ware. At that time we probably had two or three thousand employees.

Senator Gore. So this is not exactly an employee option?

Mr. Ware. No, it is not. And I do not think that the stock option privilege is useful if granted too far. I am not one who supports in general the profit-sharing plans.

This stock option contributed much to make my job more attractive and keep me from accepting another job. I know from my own experience what it means to the young executive to have a stock option, and what the stock option incentive will do to hold him on the job in the face of offers from other companies.

Also, our stock option plan was very helpful to me in building up this company during recent years. I could not have obtained the skilled and experienced men needed for this growth if I had not been able to offer the stock option incentive.

The very basis of our capitalistic system is that of incentive.

Senator Gore. Would you mind if I interrupted you there? You are outlining a very interesting situation and as we go along we can clear up some points.

You say that the sales of your company in 1939 were only $10 million per annum, and that sales have risen today to $130 million. What were these sales in 1950.

Mr. Ware. The sale figure in 1950 was $58 million. We have enjoyed steady growth over this period. I think our sales will be in the next year $140 million and in the next year $150 million or $160 million.

Senator Gore. 1950 was a time when minerals were in demand; is that not true?

Mr. Ware. Yes. They are continuously in demand.

Senator Gore. Would you estimate your sales—I am not expecting you to be exact—but would it be in the order of $100 million by 1950?

Mr. Ware. The sales in 1950 were $58 million.

Senator Gore. So the growth of your company had been assured before Congress created this loophole?

Mr. Ware. It is certainly true that a wonderful start had been made with our company. And up to that time I had been working; and my team had been working good. But as we grew, we needed more——

Senator GORE. You had been receiving salaries before that, had you?

Mr. WARE. Yes.

Senator GORE. On which you paid your taxes at the legal rate?

Mr. WARE. That is correct.

Senator GORE. So the growth and success of your company has not been the result of restricted stock option and the privilege of deferred tax liability, if at all, but it was assured before Congress passed this bill?

Mr. WARE. Our sales in 1951 were $66 million.

(The following was later received for the record:)

INTERNATIONAL MINERALS & CHEMICAL CORP.,
July 24, 1961.

Hon. ALBERT GORE,
U.S. Senate, Washington, D.C.

MY DEAR SENATOR GORE: In my testimony before the Senate Finance Committee on Friday after I had talked of the growth of our company, you asked me what our sales were in 1951, and I was unable to give you that figure. Our total sales in that year were $66 million, and at the present time they are $130 million. So you can see, we have practically doubled the volume of our business in those 10 years.

It was a pleasure to appear before your committee and endeavor to be of some help in this important meeting.

Sincerely yours,

LOUIS WARE.

Senator GORE. You say from 1939 to now you had a steady growth?

Mr. WARE. That is right.

Senator GORE. With or without stock options?

Mr. WARE. Over the period prior to stock options, that is true.

The very basis of our capitalistic system is that of incentive. During recent years rising income taxes have made it impossible for young executives with families to accumulate capital. Ours is the capital system, and we must provide opportunity to make capitalists if this system is to survive.

Skilled management people with proven ability are the hardest ones to get and hold in a company's organization. The stock option plan is one of offering added incentives to men in this category. It makes it possible for young executives to become more than just a hired hand in a corporation. Through options they obtain a share in the enterprise, and acquire the viewpoint of an owner in planning the growth and success of the business. It is impossible to do this on salary after income taxes today. We need this incentive for management very much.

I have seen, and I know, the enthusiasm among keymen for the opportunity which stock options offer them. The granting of these options is a valuable tool to generate high morale and keen emphasis among these top skilled people in the growth and success of a corporate enterprise.

It is difficult to get highly trained technical specialists, sales managers, and experienced management executives today. There is a shortage at this time, and the manager of a corporation needs and must use every device he can to obtain and hold high-grade men and keep up a high degree of enthusiasm among his staff.

The stock option with the tax advantage as provided by the act of Congress offers real incentive. If we destroy the incentives, we tend toward socialism.

In the present world situation, it is even more necessary that we encourage the development of new skill and talent. This is essential if we are to keep our corporation strong and realize the continued growth of the productive capacity of this Nation.

In our opinion, if Congress removes the stock option plan as a means of creating incentive, one more step is taken toward the elimination of incentives which are a vital part of our capitalistic system.

The president of our company delivered an address at the Harvard Business School on June 9 having the title "Stock Options—Their Morality and Practical Applications."

This speech contains all our arguments for the continued granting of stock options. I submit a copy of this speech and ask that it be made a part of the record in this hearing.

Senator GORE. Without objection, it will be accepted.

(The information referred to follows:)

STOCK OPTIONS—THEIR MORALITY AND PRACTICAL APPLICATIONS

(An address by Thomas M. Ware, president, International Minerals & Chemical Corp., delivered before the 31st National Business Conference, sponsored by Harvard Business School Association, Soldiers' Field, Boston, Mass., Friday, June 9, 1961)

Let me begin by discussing the semantics of my title, "Stock Options—Their Morality and Practical Applications."

It is natural if you wish to attack an issue to do it in the most inflammatory language, so we hear stock options attacked as a moral issue which I contend they are not.

The moral implications involved, it seems to me, are to be associated with the broader question of whether incentives are moral or not.

Stock options, one of several forms of incentives, should be discussed in terms of their effectiveness in aiding management.

The stock option program gives the chief executive a special management instrument—a precise instrument for a precise purpose. It is intended to motivate and compensate the few risk takers in the upper ranks of management. For middle management, contributing to a company, but not taking decisive risks, there is a bonus. Other forms of incentive compensation exist to attain special goals.

At the broad base of the company, employee compensation is limited to salary. Some companies have devised compensatory programs that reach into the main body of employees with incentives such as a profit-sharing program.

In my opinion, you are not going to do away with stock options unless you are ready to make the broader decision of removing incentive from our free competitive system. If we are ready to go that far, then the question of stock options is relatively minor, indeed.

The Congress of the United States in its wisdom has recognized the need for a law that would provide incentive under high income taxes for those willing to risk either their capital or their management reputation and careers.

It is notable that the Senate Finance Committee, in approving the capital gains provision of the Internal Revenue Code, defined its purpose in these words:

"Such options are frequently used as incentive devices by corporations who wish to attract new management * * * to convert their officers into partners by giving them a stake in the business * * * to retain the services of executives who might otherwise leave * * * or give their employees, generally, a more direct interest in the success of the corporation."

Not defending abuses

I do not overlook the fact that there have been abuses of the stock option system, but neither am I here to defend them.

I am prepared to discuss the well-conceived, well-directed option program as a means of achieving important corporate goals and I am prepared to discuss my views on the morality of incentives in our kind of economy.

Where the question of morality is raised, the principal arguments are that stock options are discriminatory, in that they apply only to a few, and since

the law are very often the ones who establish and direct the plan, this gives rise to a question of conflict of interest.

There is also a question of morality in the true purpose of stock options. The question, as some critics put it, is, "Do stock options exist to give a few executives added, tax exempt profits?"

To those who claim the tax law is discriminatory, the answer is "Yes," but for a very good purpose. Congress has drawn a distinction between the stock option plan and the pension and profit plans allowing special consideration to those under the former classification. In so doing, it recognizes that it is a few who take the risks in deciding the course of a business.

I have purposely raised the questions of risk at this early point of discussion because there are those who claim that the capital gains treatment was never intended to benefit the manager, but is solely for those who risk capital.

I shall consider with the language of Congress reported to further which plainly states that stock options are intended to attract and hold skilled management.

And who says there is no risk for the management executive who puts his career and a lifetime of earnings behind his belief in his company? Doesn't he risk far more than money?

The risk conditions I refer to here are very real in new companies and in companies experiencing serious difficulties of one sort or another and in need of new management. Under these conditions, and with high income taxes, what incentive is there for the successful manager to leave a stable situation and risk one full of advantages?

Speculative risks involved

John C. Baker, noted compensation authority, describes this situation vividly: "At such times the corporate outlook is dark, the demand for able executives pressing, and it is problematical whether or not the company, even under capable, aggressive management, can succeed with a rehabilitation program. Certain heroic efforts would be demanded to secure the desired results. During such a period, cash resources may be low * * * and there may be a limit to salaries which could be paid to the best available management. The man or men assuming the task of revamping a company realize fully the difficult problems and the speculative risks involved, as well as the possible danger to their own business reputation if they fail, and therefore request, or are offered, option contracts on stock as part of their payment."

Conceding that there is risk in the above situation, the critics then ask, "What about the company in a stable situation? What risk is involved there?"

I can only reply that any top manager who feels he can relax in today's fast-moving economy is already risking trouble. There is as much risk in staying at the top as there is in getting there. What risks were involved in launching Ford's Edsel or the Ilyatt? What risks did the aircraft industry executives take in developing and bringing into passenger service the Boeing 707, the Convair 880, and the DC 8?

What are the comparative risks of the investor and the top management executive in these situations? Capital can move in or out of a difficult situation with relative ease. The executive committing himself to a long-term decision must fight it out to the end and take the consequences.

I believe it was these risks that Congress recognized in establishing the capital gains feature for stock options.

Aside from tax considerations, there are critics of the corporate scene who contend that the stock option is morally wrong for any or all of the following reasons:

(1) It is discriminatory and inequitable in application.
(2) It is structured and administered by the few who derive the benefit.
(3) It does not serve the intended purpose.

I agree that the stock option is discriminatory and properly so since it is intended as incentive only for those who bear the burden of decision and take the consequent risks. This is in keeping with the philosophy that rewards should be comparable to risks.

Management's responsibility

To say that the management of a company, which is trusted with every other major decision, some of much greater consequence, cannot be trusted to compensate itself fairly is to cast doubt, not on this one function, but on the whole system of corporate management. It is a system of human beings and therefore likely to produce some human failures. But you don't condemn the system for

the omissions or commissions of a few. If there are malpractices in the handling of stock option provisions, you can be certain that there are malpractices in other management areas. In these instances, it isn't the stock option that should be eliminated, but more likely it is the management.

Remember too, in this question of management's faith and morals, a further check on the stock option plan is the required ratification of stockholders.

The criticism that stock option plans do not serve their intended purpose is generally based on the argument that executives use the capital gains tax provision to dispose of their stock for quick profit.

In the absence of statistics, it would be hard to prove or disprove this, but where it exists to a great degree it suggests that the corporation is deficient in some important areas. Why would a top executive rid himself of stock in his company? There may be good and valid reasons, some of which we will discuss. It may be an outright case of financial hardship.

But in a properly constructed plan that integrates corporate goals, provisions for growth and sound compensation practices, there is little temptation for the executive to dispose of stock acquired under option.

In the absence of statistics, I checked the records of our own stock option program and found that 87.5 percent of our employees, who have exercised their options, have held their stock. I can't offer this as conclusive, but I would like to believe that it reflects the care we put into the development of our plan and the attention we give its administration.

Stock options immoral?

I believe I have covered the major criticisms implying that stock options for one reason or another are immoral. Before you conclude where you stand on this, I think you might ask yourself these questions:

Is it wrong to use a compensation program as an incentive to bring about desirable corporate goals?

Is it wrong to compensate executives with due regard for the risks that they take?

Is it immoral to use the capital gains feature of the tax law to retain and stimulate top management?

Is it wrong to provide a means of supplying a proprietary interest in the company to able executives?

In my opinion, the answer is emphatically "No." Option plans have the approval of an overwhelming majority of shareholders and of Congress. They have been tested and approved in the courts. There is no way under a carefully developed system of corporate checks and balances that a self-dealing benefit system could be perpetuated by management without deliberate collusion. To condemn the whole option system as bad because of the abuses of a few, is to ignore the good that incentives accomplish under our kind of economy.

While I am interested in these moral aspects of the stock option principle, as chief executive officer of a corporation, I am most concerned with its performance as a sophisticated instrument of modern management.

Let me put the stock option in its proper perspective as I see it. First, you determine the goals of the corporation; you build the structure to attain these goals; you people the structure; you then provide the incentives that will make it work—salaries, bonus, and finally, after all these, the stock option.

Misconceptions plentiful

Simple and clear as this seems it is amazing to me to discover what misconceptions are publicly printed and stated about the real purpose of the stock option. And, I regret to admit that in some instances top management executives have been derelict in this regard. Their comprehension of the true purpose of the stock option, in some instances, has been shallow and they do themselves and all managements a disservice by statements revealing their ignorance. Is it any wonder, therefore, that critics of management center their salvos of attack on the stock option as a tax dodge with complete disregard for its value in attaining corporate goals?

It is only after careful thought has been given to planning corporate goals, corporate structure, staffing and compensation that the stock option should come into consideration. It cannot hope to serve its purpose as an incentive until all of the other steps have been accomplished in that sequence.

Functioning at its best, the stock option benefits not only the recipient individual, but the corporate entity and the individual stockholder.

How does the stock option benefit the corporate entity?

It attracts and tends to hold top managerial talent. Properly conceived it can help the company meet the competition for managerial talent while still fulfilling other corporate objectives. However, the stock option plan adopted solely for competitive headhunting not only harms the particular corporation by the narrowmindedness of its purpose, but damages the repute of the business community generally.

Stock option plans work to equate, to some degree, the small and large companies. This is true of the new company in need of managerial talent; or the small company short of cash. It also equates the weak company with the strong when the weak company needs top managerial talent to put it back on its feet.

Stock options benefit the corporate entity by producing the best possible performance from key employees who are motivated by their proprietary interest.

The stock option makes corporate goals more meaningful to employees with a vested interest in the company's success.

The stock option helps unite management and the stockholders in a common purpose.

It promotes loyalty to the corporation by identifying individual needs of executives with corporate goals.

It provides corporate growth by encouraging executives to take the calculated risk.

Capital builder

How does the stock option function as incentive for the individual? Mainly, I would say, by recognizing human needs which are not satisfied by other forms of compensation. The most attractive feature is the opportunity afforded the executive to build capital. This is particularly appealing to the long-service employee at the peak of his career and approaching retirement whose response to incentives reflect his particular situation.

It gives the talented employee a proprietary interest in his company.

It puts a premium on creativity and encourages personal contributions.

It stimulates more participation in the financial growth of the company.

It directs individual efforts toward desirable corporate goals.

It provides a training feature for younger executives who strive to qualify for positions that would provide them with a stock option.

I believe the stock option system also benefits the stockholder even though this point has been contended by some.

There are values for the stockholder in every one of the stock option benefits I have cited so far. To conclude otherwise would be to admit that the stockholder's interest in his company is motivated by aspirations other than its successful operation.

A principal gain that the stockholder gets from the granting of options is a greater understanding of the stockholder's interests on the part of management.

Perhaps the gains I would like to list can best be realized by answering the chief complaints against stock options raised by some stockholders.

Mutual benefits

There is the objection that somehow stock options dilute equity. On the contrary, one of the appealing features of the stock option is that it requires no cash outlay by the corporation. As the option holder benefits, so does the shareholder, through appreciation of stock values.

I am reminded here of an old Mexican gardener who planted tender new shrubs according to a ritual he had developed—a little bit of soil, a little bit of fertilizer and then, as he completed his task, he would remark, "a little bit of time."

My point being that just as the stock option functioning properly produces benefits in time for the executive, so does it produce benefits for the stockholder in time.

I think that complaints about dilution of equity made by stockholders fail to consider the long-term gain which is the goal of stock option.

Another argument advanced by some stockholders is that if executives have faith in the company they should buy shares on the open market.

It goes without saying that faith in his company is essential in the good executive. But his job calls for demonstrations of faith and sacrifice that exceed, by far, the investment of his money. It is no secret that the successful

corporation executive in the United States is a health risk. At times the demands of his job will cost him some personal happiness and maybe some domestic tranquillity. In times like these, it is only faith in himself and what he is doing that keeps a man going.

The argument that executives should buy their shares on the open market overlooks a fundamental feature of the stock option which is that the executive, at the outset, has only his labor and skills to invest, until he can build sufficient capital. That's why the option provides him time to build his company, increase its value, and thereby create the capital he needs to become a partner.

This leads naturally to the argument that executives should be required to hold stock acquired under option. While the end envisioned by this argument is most desirable, the means is unfair and discriminatory. If the stock appreciated in value during the option period, it was undoubtedly attributable to some measure of good management. Once the executive takes up his option, he is an investor, like anyone else, and he must be free to operate on the market as he will.

The Romney sale

Many of you will recall what happened last year when George Romney sold 10,000 shares of American Motors stock. The news precipitated a flurry of selling and American Motors lost 9½ points in 2 days before holding at 69.

He had not sold the stock, said Romney, for any lack of faith.

"I sold it," he said, "because there is no other way by which I can increase my outright investment in the company's future."

Time magazine, telling the story, said:

"As a vice president, Romney had managed to buy 3,240 shares in his company. When he became president, he got an option for 85,000 shares."

Romney voluntarily cut his salary when his company was in the red and meanwhile the stock dropped below the option price. Romney was in a bind.

"I had to borrow to pick up those options," he said. "A fellow in my position, under the tax laws, is not in a position to buy stock except by borrowing."

Romney borrowed enough money to buy 20,500 shares, leaving 14,500 still to go. At that, it was a gamble: With American Motors' spotty dividend record, the carrying charges on a big loan could be a sizable expense.

As American Motors moved ahead, Romney got 2 more sets of options: one for 21,000 additional shares at $51.82½ and another for an additional 21,000 shares at $50.29.

By selling 10,000 shares, Romney realized $900,000, of which $200,000 went to pay capital gains tax, another $200,000 for debts remaining from his first purchase, and $70,000 for tithings to his church. He netted $430,000, about $200,000 short of what he needed to pick up 14,500 shares on his first option plus another 12,000 shares available that same year on another option. By paying off his first debt, he could borrow again. Time magazine figured that when he was all finished he would own 40,840 shares, or 28 percent more than when he started.

The value of the Romney story is that it was given such widespread public attention through the press. It may have caused him personal embarrassment which no other investor in his company can expect to encounter. It may have seemed to him and his family that this was an invasion of their privacy. But it illustrates the effort to which a top manager must go to create enough capital to invest in the business he is building, while maintaining the stockholders' faith in his integrity.

Stockholder support

Perhaps the most convincing evidence of how most stockholders really feel about the stock option is revealed by the decisive support they have given it in approving plans in one company after another. Results of a New York Stock Exchange survey, soon to be published, will reveal that 61 percent of the 1,135 companies with common stock listed on the exchange have some form of stock option.

My argument in support of the stock option is predicated on the fact that the plan is well conceived, well planned, and well administered. Recall at the outset that I said its proper functioning depended not only on how it was applied, but even where it was introduced in the sequence of a company's development—after the goals are set, after the organization is structured, and peopled, after other compensations are provided, then the stock option plan becomes meaningful.

What are some of the considerations in establishing a good stock option plan?

One consideration is the important relationship of option shares to executive salary. The number of shares offered should be large enough to provide an incentive, but not so large as to discourage hope of acquiring the total. Counsel on this subject would indicate that 1½ to 2 times annual salary is not incentive enough and that more than 4 or 5 times annual salary is too much. The median arrived at in a recent survey of options granted to 50 top executives was 2½ times annual salary.

Since one of the most acceptable features of a stock option is that it makes the executive a partner in the business, retention of the stock should be strongly encouraged by the plan, but not stipulated.

It seems to me that there is a better chance of the stock being retained if the executive option is not granted as promptly as other compensation.

Appreciation of the value of an option increases during the waiting period that many plans require before the option can be exercised. As a practical matter, the Securities and Exchange Commission rule, which requires an officer or director to hold optioned stock for at least 6 months after its purchase, encourages retention of the stock as an investment.

Retention advisable

Some plans require that the optionee sign a statement to the effect that he, his surviving spouse, and children are bound to acquire the stock for investment and not for distribution.

While retention of the shares by the executive is highly desirable, it seems to me that for the stock option to be practical it must recognize that the executive will be less likely to invest either his money or his time in a company if his stock is nonnegotiable. If he has to risk a depression, or a major market slump with no means to protect his investment, no executive will exercise his option. He would be in the category of second-class investor.

Unwarranted restriction destroys the incentive which is the main purpose of the management stock option.

As a means of encouraging executives to hold their optioned stock as an investment, I see greater value resulting from a waiting period of a year or two before the option can be exercised and in limiting the amount of the option that can be exercised in any one year.

As a practical argument for its success, the stock option should be limited to the few executives who are in a position to influence the company's growth by their decisions and contributions.

Where you place the responsibility and risk, you should also place the rewards for success.

Reported practices would indicate that most companies have adhered well to this stipulation by keeping the stock option incentive for responsible top management. A random study of stock option plans showed that in the median company one-half of 1 percent, or 30 out of 5,900 employees, received stock options.

Another consideration in determining who should be covered by stock options is that coverage should be equitable. All top management with comparable responsibilities for the growth of the business should be included.

Financing assistance

Some method of assisting executives with financing in order to acquire their options is also desirable. Without this, it is almost certain that the executive, whose sole income is his salary, will be forced, in this era of high taxes, to sell some of his shares in order to acquire permanent holdings. The Romney incident illustrates this.

Several methods of financing stock options through time payments, bank loans, or loans through pension funds, insurance companies, and private individuals not subject to the Federal Reserve Board Regulation U, are followed in practice, but there is value for the company if a purchase plan is provided. It helps to insure that the plan will work as desired.

The kind of shares used for stock options is often a matter of some concern to stockholders.

The use of unissued or treasury shares, which is the common practice, brings additional funds to the business and at less expense than buying them on the open market.

This has raised the question of dilution of equity. But objections of this kind shrink before the fact, when you examine the proportion of shares available for option in most companies, compared to the total shares outstanding.

In 100 plans reviewed by the New York Stock Exchange in 1955 and 1956, the shares available for option, compared to total shares outstanding, ranged from less than 1 percent to 14 percent—the median being 4.7 percent.

Option price amendment

Discussion of the practical features of a stock option plan must include consideration of amendments to lower the stock option price. If we are to be practical, we must realize that the price of option shares is determined on the free market. If unusual circumstances such as recession, or a technological revolution in an industry, should drop the stock price below the option for a protracted period, some amendment of the option price is necessary if management is to employ this kind of incentive with effect.

A few companies have introduced price amendments with stockholder approval and their action was upheld by the courts, but I feel that good faith dictates that amendments of this kind should have stockholder approval.

At this point, it occurs to me that perhaps I am taking too much for granted in assuming that because you invited me here you know a good bit about our company. Unless you are a bulk buyer of minerals and chemicals, you wouldn't know our products. But belive me sincerely when I say I wish all of you were bulk buyers of minerals and chemicals. We certainly would welcome you.

We have one major consumer item called Ac'cent ® which has the reputation of being sold through more chain retail stores than any other food product in the United States. It is a monosodium glutamate product which brings out the natural flavor of meats and other foods and it's popular with cooks, from the professionals to the outdoor home barbecue type.

We are the world's largest source of food-producing minerals—namely phosphate and potash—and a leading producer of feldspar and clays used in the foundry industry.

I relate this to acquaint you with the fact that ours is a basic industry which experiences strong competition. We appreciate the importance of the dollar.

It might appear to you that a fertilizer company is not in competition with Time magazine or Texas Instruments, both of whom are also represented on your program here. But we are in competition with them. We compete with them for new capital from the money market; we compete with them for the investor's dollar; and we compete for the best skills and talents in the management field. In these and other areas managements compete with management. This is best illustrated in the practice of financial experts who appraise the vigor, the skill and the age of a company's management before drawing their conclusions.

In this competitive situation, I regard the stock option as a highly specialized instrument designed to bring about management ends.

I have drawn the perspective in which I believe it works and that is—after the corporate goals are set, and the structure to attain them is built, after the key people for the structure are secured—that is when you provide the incentives such as salaries, bonuses, and stock options.

Meets today's needs

Uniquely suited to our times and the needs of our economy, the stock option is well placed in the compensation portfolio of the top executive who is expected to provide his company's growth.

In setting the goals of our company, we have settled for no small plans. The same high standards have prevailed in setting the structure and in manning it.

Our goals are big in the sense that we serve a national purpose by helping to feed the world, while maintaining our free and independent competitive system. The importance of this role is clear when you realize that American agriculture, which we serve, has reached a point of efficiency where three-tenths of 1 percent of the world population now produces 15 percent of the world's food.

Let me give you a respected authoritative opinion as background, for why I think that the stock option is a fundamentally sound part of our economy and an unusually effective way of maintaining it.

The noted historian Arnold Toynbee, in his examination of 23 civilizations, concluded that all but one—our own—had died, or is in the death throes. He found one common weakness was the major cause in each demise and that is the drying up of creative leadership. The failures resulted from a weakening of the will to meet new difficulties and from attempts to solve current problems with old solutions that did not meet present needs.

So far, this civilization has fostered man's basic intuition to strive and to grow. Here in America, under such incentive, the corporation has developed and achieved its finest performance, unequaled anywhere in the world for the variety and greatness of its contributions. Nowhere else have the interests of the stockholder, management and board of directors worked in such harmony.

If our civilization is the one to survive, after 23 failures, and if that survival is to be under our free and independent system, then we must develop leadership with the best incentives at hand. Survival and growth demand the highest level of performance we can command.

If, on the other hand, we fetter the intellect of our best creative leadership and destroy the incentives so vital to growth, then the outcome of this civilization is a matter of cold statistics.

We are No. 24.

Mr. WARE. I very much appreciate the opportunity to appear here before you today, and I thank you.

Senator GORE. Questions?

Senator CURTIS. Mr. Ware, what did the shareholders gain or lose in your opinion by the institution of a plan of stock options in your company?

Mr. WARE. Well, I think when the shareholders approved our plan of stock options, they established a vehicle of great help to the management in the enlistment and encouragement of executive personnel. I do not think he lost anything.

I think that the granting of options at that time, at that place, which is market or near market, did not cost the corporation. But it added incentive, and incentive today is what we need.

I know of young men who did not want top management jobs because in many instances they do not have opportunity to accumulate, and they take great responsibility without opportunity and without the incentive that they should have. High taxes have destroyed incentive. And if we destroy stock options we take one more step toward destroying incentive, in my opinion.

Senator CURTIS. Now, do you think the value of the shares has increased—I am not just talking about the fluctuations of the market—by reason of the management team that you say you have been able to hold through this restricted stock option plan?

Mr. WARE. I do, sir.

Senator CURTIS. And you think it is a significant factor in the long pull?

Mr. WARE. I certainly do.

I have in mind one of the top, essential men in our company, who was in my office yesterday. And as I do sometimes, I asked "How are you getting along?"

And in the course of our talk he said, "That stock option, that is very, very good to me, and I am very happy to have it."

And I happen to know that he is an expert in a certain field in which there is a scarcity, and I also know that he was recently offered an opportunity with another company in which they said, "Write your own ticket." But he believes in our company. And he now has in his hand an option for 5,000 shares. And he and his family are looking forward some day to realizing on those shares and becoming an owner in the company and realizing further in its continued growth.

Senator CURTIS. Do you feel that in the main the stock options have been worked out so far as the details are concerned advisedly and with due regard for everybody's interest, including the general public and the shareholders?

Mr. WARE. I can say that there are instances of abuse of the stock option plan, as there are all things. I think by far the majority have been workable.

I know that Ford Motor Co. has been cited here today as one, and of course there are many other fine examples, where they have been working and where they have not been abused.

Usually a man who attains the management of a large corporation is a man of integrity, and he does not abuse matters of that kind. He has in mind his obligation to his shareholders, his obligations to his personnel, and his obligation to the public. He does not look in one direction alone.

Senator CURTIS. Do you have in mind any particular abuse or abuses that a company ought to look out for if they undertook to initiate such a program?

Mr. WARE. I think that stock options can be too high a percentage of the total shares outstanding. And I think you have to think, you have to keep in mind what is a reasonable proportion of the equity that has been issued. I think that stock options can be given to people who are, perhaps, not qualified. It may be that a corporate manager may show undue favoritism.

But those things, they are in all lines of business. A man who has not high standards can abuse almost anything. In my opinion it is very hard to control, by laws, all details of things of that kind, and we usually have to look to the quality of management.

Senator CURTIS. Do you think it is wise for a man, when it is initiated, to provide that after the option has been exercised and the stock aquired, the person who is benefited by it may continue to hold the stock for a reasonable length of time?

Mr. WARE. Yes, I think that is true. I think we have such a plan. But I think the more restrictions you put on the option, the less attractive the incentive. I think the man looks on it clearly as an opportunity to make money, and an opportunity to become a capitalist. And as you put restrictions on, you lessen that opportunity.

Senator CURTIS. What is your feeling as to whether or not it is advisable that management and ownership should have the same interests?

I have not stated my question very well, but you know what I mean.

Mr. WARE. Yes, I know what you mean. And I subscribe to that, sir.

Often I say to a man who comes in and asks for an appropriation of $5 million to build a plant that has a lot of risk to it, I say, "Look, Joe, let's think you owned this company and it is all yours, you are the owner of it, would you take that risk with your own money?"

That is the way you have to think in a corporation.

Senator CURTIS. In other words, it is your feeling that you get sounder management, which in turn is reflected in sounder aspects to our economy if managers have the responsibility and the insight, as well as the rewards, of ownership?

Mr. WARE. I think that is true.

Senator CURTIS. Rather than if they are just hired to manage somebody's else money?

Mr. WARE. That is right. And I think that is true.

I think you want the man, in addition to being a specialist, or a skilled manager, you would like for him to be an entrepreneur, to build the company as if it were his own. And that means, when he has a stock option—which otherwise he could not afford to buy—he puts himself in the position of thinking as an owner, as an entrepreneur.

Too often managers think of management only, and they do not get that viewpoint, that you are spending money; when you spend money in a corporation you should think of it as your own; when you take risks in a corporation, you weigh those risks, you should weigh those risks and think of it somewhat as if you are risking your own money.

And I have always tried to instill into our managers that thinking in the affairs of our business.

Senator CURTIS. An owner is concerned about the long-range result, too?

Mr. WARE. Yes. And I do not think that he is concerned entirely with profits, as some people say.

I think an intelligent owner is one who recognizes his obligation to all phases of business life, including the public.

Senator CURTIS. That covers what I had in mind.

Senator BENNETT. I have no questions.

Senator GORE. Do you believe our tax laws should be just and fair?

Mr. WARE. Of course.

Senator GORE. Do you believe that all citizens should pay their fair share of taxes in accordance with their income?

Mr. WARE. And the law. In accordance with their income, as provided by the law.

Senator GORE. Do you think the law should provide that citizens pay fair and reasonable taxes in accordance with their income?

Mr. WARE. Yes.

Senator BENNETT. Senator, may I ask a question as to what you mean by "in accordance with their income"?

Do you mean that all income, however derived, should pay exactly the same tax, that there should be no exemptions, no family exemptions, any man that gets $1,000 should pay the same tax in accordance with his income?

Senator GORE. I was not assuming such a possibility.

Senator BENNETT. Well, is this not another case of a situation—the import of your question, as I got it, was that everybody should pay the same tax according to his income. And I think the whole basis of our tax law recognizes differences that apply different tax rates to equal amounts of income under different conditions.

Senator GORE. Well, every taxpayer has an exemption of $600 for each dependent child. I would not deny that. I was not even referring to that.

But the distinguished witness described a situation in which 20 or 25 so-called key employees of a corporation with some 2,000 employees received income upon which, under the law, they are not required to pay taxes at the time they received the income.

Senator BENNETT. You and I have argued that before, as to when the income actually becomes income to them, and maybe that is the basis of this disagreement.

Senator GORE. Well, I am perfectly willing to engage further in a discussion of that point, but I will not burden the witness with it.

Thank you very much.

Mr. WARE. Thank you.

Senator GORE. The next witness is Mr. John C. Davidson.

Assuming it is agreeable with the chairman of the committee, we will hear Mr. Davidson and recess for lunch. Mr. Dan Throop Smith will be the first witness at 2 o'clock, and the other witnesses will follow in order, as listed.

You may proceed, Mr. Davidson.

STATEMENT OF JOHN C. DAVIDSON, VICE PRESIDENT OF THE NATIONAL ASSOCIATION OF MANUFACTURERS IN CHARGE OF THE GOVERNMENT FINANCE DIVISION

Mr. DAVIDSON. My name is John C. Davidson. I am a vice president of the National Association of Manufacturers in charge of its Government Finance Division. I appear here in behalf of the association, in opposition to S. 1625 which would withdraw capital gains treatment of stock options.

Mr. Chairman, if possible, I would like to read through my statement before questioning.

The NAM is a voluntary membership corporation made up of over 18,000 business concerns of all types and sizes throughout the United States. More than 80 percent of our membership is small business. In fact, 28 percent of the membership employ 50 or fewer persons, 46.5 percent employ 100 or less, and 83 percent have 500 or fewer employees. The association thus speaks for a broad, diversified, and substantial segment of the country's productive—and taxpaying—enterprises.

It is not true that the tax treatment of stock options constitutes a loophole. Instead, this treatment is a logical and reasonable application of tax to the financial results of a type of transaction which serves the public interest.

We live in a time when taxation is such an important factor in economic decisions that other important and sometimes overriding factors tend to be downgraded. Thus, a decision may be ascribed to tax consequences even though it would be made if the tax factor were unimportant. The term "tax incentive" actually is a misnomer because a tax can never be an incentive but, instead, must always, to some extent, be a disincentive. Consistently, it is the stock option which is an incentive, not the tax treatment thereof. Taxes are paid on the gains from stock options just as they are paid on the gains from the ownership of assets acquired in others ways. Stock options would provide even greater incentive if no tax at all were payable on gains. Thus, to some extent, the tax operates as a disincentive.

The reason why the stock option is called a tax loophole by some, and is generally thought of as a tax incentive, is that the tax is levied at capital gains rates instead of ordinary income tax rates. The fact is that if stock options were taxed at present income tax rates, the incentive for their use would be effectively nullified.

Stock options have been used for many years. Their use was not brought into being because of taxation. Instead, the problem from

the beginning of income taxation has been to find the method of taxing the gain from stock options which would be consistent with the nature of the transaction. The problem was a loose ball until a Supreme Court decision in 1945, and subsequent Treasury regulations, effected a tax veto over any practical use of options. In 1950, the Senate Finance Committee took the initiative in overriding the veto. The words "restricted stock options" were introduced as words of art necessary to the establishment of rules for the taxation of options. In using these words, there obviously was no intention to change the basic nature of an option, but only to apply logical tax treatment thereto. Experience confirms the wisdom and judgment brought to bear upon this problem in 1950.

It is not difficult to find the underlying basis for the objection to the tax treatment of restricted stock options. This is the belief that the public interest is furthered by subjecting the maximum amount of all types of economic values to the steeply graduated rates of income tax. From the standpoint of economics, it is readily demonstrable that the public interest is adversely affected by such taxation.

Stock options constitute an incentive to increase the growth and profits of a company. Growth and profits are a highly desirable and necessary source of capital. Combined with managerial capacity and energy and technological advance, all progress is based on capital. The greater the accumulation and use of capital, the greater will be the progress of any economy.

In the doom and gloom of the 1930's, these truths were lost sight of in the prevalent belief that our economy had reached a stage of economic maturity. On this false premise, it became popular to view capital as though it were inherently bad and, hence, an expendable element in the economy. Thus, tax policy was heavily oriented to the prevention of new capital accumulation, and to the destruction of capital already accumulated. The Government has been feasting ever since on the seed corn of progress.

Since World War II, our Nation has had a sort of double standard for viewing capital. On the one hand, our policy has been to recognize the need for capital in other countries, and, hence, to contribute a large amount of our resources to building and encouraging the building of capital supply abroad. But, domestically, national policy has reflected little concern for the good of our people and of our security which would result from greater capital accumulation and use.

There has been many reasons for shortchanging the domestic problem. One has been the continued belief that greater economic growth is induced by more Government spending, rather than accumulation and use of more capital in the private economy. In West Germany, we see the economic results of a government which has taken precisely the opposite but correct view.

Another reason for the neglect of the capital problem at home is the widespread notion that we have limitless financial resources. Fundamental to this notion is the assumption that future growth is largely a matter of using available capital, instead of accumulating more capital.

Actually, there never is any significant amount of surplus capital in a free economy. When capital becomes available, it is used.

Hence, the rate of growth in the future is always dependent upon the rate of accumulation of new capital. If more capital becomes available, it will be used. If more capital does not become available, we will suffer the economic consequences. In recent testimony before the House Ways and Means Committee, Secretary of the Treasury Dillon stated:

> As we look back over the past century we see that our record of economic growth has been unmatched anywhere in the world. But of late we have fallen behind. From an historic growth rate of 3 percent per annum in gross national product (1909–56, in constant prices), we have fallen to 2 percent in the latter part of the 1950's. In the last 5 years Western Europe has grown at double or triple our recent rate and Japan has grown even faster. While there is some debate as to the precise annual growth rate of the Soviet economy, CIA estimates that their GNP grew at a rate of 7 percent in the 1950's. Clearly, we must improve our own performance. Otherwise, we cannot maintain our national security, we cannot maintain our position of leadership in the eyes of the world, and we cannot achieve our national aspirations.

The basic reason why these countries have grown more rapidly is that they have developed and used more capital. Some time ago, Mr. Allen Dulles, Director of the Central Intelligence Agency, stated that Russia's capital formation rate was in the order of 30 percent of their gross national product.

Statistics on capital formation in leading western countries for 1959 are as follows:

Gross domestic capital formation percent of GNP 1959

Germany	28
Austria	28
Italy	21
France	18
Belgium	17
Britain	15
United States[1]	15

[1] Department of Commerce.

Source: Statistical Year Book, 1960, United Nations, table 166, p. 471.

It may be noted that if the domestic rate had been 18 percent instead of 15 percent of gross national product, capital formation in 1959 would have been some $15 billion higher.

The area of lag in domestic capital formation is in business expenditures for new plant and equipment. This is shown by the record over the past decade, with all figures adjusted to constant dollars of 1960 value, as follows:

Business expenditures for new plant and equipment, 1951 through 1st quarter 1961

[In billions of dollars, adjusted to 1960 price level]

Year:		Year—Continued	
1951	32.2	1957	38.9
1952	33.0	1958	31.3
1953	34.7	1959	32.6
1954	32.6	1960	35.7
1955	34.0	1961 (1st quarter)	34.0
1956	39.1		

Note: Data in current year dollars drawn from table C–30, p. 162, Economic Report of the President, Jan. 18, 1961. Conversion to constant dollars of 1960 value effected by applying of "implicit price deflator" for producers' durable equipment used by the Department of Commerce in converting gross national product to constant dollars.

Since capital is inherently good, it must follow that the ownership of capital is also good. While there certainly are many reasons why there should be widespread ownership of business, it seems the most reasonable of propositions to believe that significant ownership of capital by the managers of business is good. In this light, it is difficult to see how there can be any philosophic quarrel with the present tax treatment of stock options.

There is, however, one point which is made in criticism of the present situation which deserves consideration; namely, that the practical difficulties of equity valuation preclude the use of stock options by small owner-operated corporations which desire to bring in new blood with opportunity for acquiring proprietary interest. It seems to me that this is a situation in regard to which an inaccurate valuation would have no adverse effect on the public interest. The Federal revenue would be enhanced by the economic results from diffusion of proprietary interests in this manner. Hence, my advice is not to be too much concerned about the precise accuracy of equity valuations where there is no established market, but, instead, to accept the judgment of proprietors based on whatever guidelines may seem most practical.

The desire to expose the gains under stock options to income tax treatment is rested on the claim that such options are used basically as a substitute for compensation instead of as a means for creating proprietary interest in a business. This is an example of dealing with a symptom instead of the source of a problem. If the problem were dealt with at source, and in a manner for serving the public interest, all income tax rates would be brought down to reasonable and moderate levels. (Quite apart from the matter of stock options, such action should be taken to enhance our domestic well-being and national stregnth and security.) Then there would be no tax reason to substitute stock options for added compensation. I would hazard a guess that expansion in use of stock options would nevertheless continue because of their incentive effect; further, that the present tax treatment of these options would no longer be in serious dispute.

Other witnesses in these hearings are testifying to the manner and means by which proprietary interest in business made possible by stock options contributes to more efficient management and, hence, greater profits and more capital. Just as capital is required for greater economic growth, it also is required for the creation of new jobs and better jobs. Consistently, withdrawal of the capital gains treatment of stock options would result in fewer jobs and poorer jobs. It would be impossible to precisely forecast the number of jobs involved in any one year, or over a period of years. However whether the number of jobs involved would be 1,000, 10,000 or 100,000, the withdrawal of capital gains treatment of stock options would be a poor service to the American citizens who otherwise would have these employment opportunities.

In your statement upon introduction of S. 1652, Senator Gore, printed in the Congressional Record of April 14, an estimate is made of $100 million annually in revenue pickup to be expected from enactment of S. 1625. I would be much more inclined to believe that there would be a net revenue loss, perhaps of significantly greater magnitude over the years. However, if his estimate is taken as the basis for

hypothesis, then it must be assumed that the $100 million revenue increase to the Government would mean an equivalent decrease in capital supply. In its case in support of its initial tax program, the administration estimated that a $1.7 billion tax reduction for industry would result in the creation of 500,000 jobs. To the extent that this is a defensible estimate, it would indicate that enactment of S. 1625 would result in the loss of 30,000 jobs, on the basis of the $100 million estimate.

One of the myths going back to the origins of our present tax structure is that high tax rates on personal and business incomes benefit the weak. Nothing could be further from the truth. More capital means the relatively greatest benefit to the weaker sectors of the economy—the people who need jobs and then better jobs—the enterprises which don't get started and can't keep going or growing because of inadequate financing—the areas of the country in which incomes and living standards are on the lower side of the scale—the States which cannot hold their well-trained young people because of greater opportunity elsewhere. Except for the inherent goodness of capital, the separate States through their industrial and development commissions would not be engaged in a constant search for new capital investment. All of the States and commissions combined, however, cannot induce a higher net total of new investment than is possible from the use of the capital which is accumulated after Federal taxes.

Enactment of S. 1625 would be a step in the wrong direction. We live in a capital-minded world, but we are not doing well competitively, measured either by rate of increase in human well-being at home, or our national strength and security looking abroad. As never before, the desperate need is to turn national attention to the release of the tax blocks to capital accumulation and use. It is not a time to give serious consideration to the withdrawal of such protection from excessive rates of tax as may be afforded by present law. It certainly is no time to reexpose to excessive income tax rates economic values which are capital assets by their nature and should never be taxed otherwise.

Senator GORE. Thank you, Mr. Davidson, for a very interesting statement.

I find it particularly interesting that you say that if, as a result of the enactment of the bill that I introduced, tax revenue of $100 million would be brought into the Treasury, 30,000 jobs would be lost.

Suppose we make that a billion dollars, how many jobs would be lost?

Mr. DAVIDSON. Again, Senator, I was using the benchmark which the administration used in its testimony before the Ways and Means Committee. I am not saying that that benchmark is right or wrong, I am saying that taking that benchmark and applying it to $100 million estimated revenue, you would get a loss of 30,000 jobs. On that basis, a billion dollars would mean 300,000 jobs lost.

Senator GORE. I am just trying to understand your point.

Now, if $100 million is saved by the closing of this loophole in Government revenue, and 30,000 jobs are lost, would you say that is bad?

Mr. DAVIDSON. I would say it would be tremendously bad to transfer $100 million from the private economy to the Government and to lose 30,000 jobs in the private economy as a result of that action.

Senator GORE. Suppose as a result of increasing taxes otherwise, we get the same result?

Mr. DAVIDSON. If the effect of taxation is to lose jobs in the private economy, I think that is prima facie bad.

Senator GORE. Taxation is really a terrible thing?

Mr. DAVIDSON. Your present kind of a tax system, I think, is pretty bad, Senator.

Senator GORE. Then the way to solve our problems, I take it, is to create more tax loopholes?

Mr. DAVIDSON. No, sir; not at all.

The association which I represent has for years emphasized that the major consideration in taxes is the rates. We are not on the record as—we are in no sense an organization which has tried to find ways and means for circumventing rate structure. We think that the fundamental problem is the rate, and we think that basic consideration should be given to reducing the rates; that is our position.

Senator GORE. I will not lead you to the inevitable consequence of your logic.

I wonder how many members of your organization possess restricted stock options.

Mr. DAVIDSON. I happen to like them, Senator.

Senator GORE. Do you have any statistics on the extent to which the restricted stock option is used?

Mr. DAVIDSON. None at all. I have not made a special study of the use of the option.

Senator GORE. Well, if you have no knowledge about how widely it is used, why do you think it is such a good thing?

Mr. DAVIDSON. Because I think that ownership is a good thing. I think that it is the strongest and most vital influence on our society, I think it is the most real and vital method of expanding ownership to the people who are perhaps logically the owners.

Senator GORE. I can agree with you on that.

Ownership, proprietary interest, is a laudable goal. It adds to the strength of our economy. We are speaking here of a special privilege which is, on the one hand, compensation to an employee, a so-called employee, and secondly, a gimmick which permits him to avoid his tax on the compensation he receives.

Are you in favor of that?

Mr. DAVIDSON. I of course do not agree with those propositions, Senator. I do not think you are correct in your statement of what this tax treatment of stock options is.

I do not think that a stock opion is a special privilege, and I do not think the tax treatment is a gimmick.

Senator GORE. You do not think the privilege of buying IBM stock at $137 when it is selling at $700 is a special privilege?

Mr. DAVIDSON. Senator, I am not familiar with the use of stock options by any particular company, including IBM. But I believe by their basic organization there is nothing quite as democratic as an American corporation. The stockholders and their board of directors have the right to make a decision as to what would serve the economic interests of that company. And the stockholders of IBM, having made that decision, it would seem to me to be a good decision.

Senator GORE. Let us not refer to IBM particularly. Let's take a hypothetical case.

As spokesman for the NAM, you have just expressed the view that the restricted stock option does not constitute a special privilege.

Mr. DAVIDSON. That is correct.

Senator GORE. Would you be in favor of extending that privilege, then, to all of the employees of the corporation?

Mr. DAVIDSON. Senator, I think whether or not a company uses a stock option and who it gives it to within the company is entirely a decision of that company.

Senator GORE. I am not arguing that. But you say it is not a special privilege.

Would you confine this to the few employees who constitute the board of directors, or the corporate insiders, the management? If it should be confined to these special few, would that make it a special privilege?

Mr. DAVIDSON. It seems to me, Senator, you are confusing the purpose of the option.

The purpose of the option is to serve the interests of the company and, obviously, a company would give the option to whoever it decided would serve its interests.

Senator GORE. I am trying to understand you, to understand your point of view.

Mr. DAVIDSON. I am trying to express it, Senator.

Senator GORE. Do you, in fact, still contend that an option granted to a restricted few is or is not a special privilege to those few?

Mr. DAVIDSON. No; I do not think it is a special privilege at all.

The option is granted because those who grant the option think that granting it will bring back a return to them. And certainly it is a quid pro quo, there is no special privilege.

As a matter of fact, I think the owners of property do not use that property in any way, but they think it will bring back something extra to them, or perhaps the special privilege is to the stockholders because they expect to get more out of the company.

Senator GORE. Do you regard it as a reward to receive it?

Mr. DAVIDSON. I regard a stock option as an opportunity to participate in ownership in order to improve the effectiveness of the operation of a particular business.

Now, I do not think these labels mean as much as you seem to think they do, Senator. It seems to me that the fundamental question is, Is this going to help the company?

And, obviously, it would not be done if it were not going to help the company. And I do not think—I do not care what labels you put on it, it does not make any difference, it just serves a good economic purpose, it treats of the sales of the company, the profits of the company, the opportunity of the company to offer jobs; I think this is good, and I think we should be happy that such an instrument is available to accomplish these results.

Senator GORE. Do you not think that this valuable privilege to exercise an option to buy stock much less than its current market value is a reward, or privilege, or incentive? How do you describe it?

Mr. DAVIDSON. I look on it as basically a contractual arrangement between an employee and an employer. The employer decides that this kind of an arrangement will benefit the company.

Senator GORE. If it is good for one, it ought to be good for two.

Mr. DAVIDSON. Not necessarily.

I mean, you might have a company in which the management decides that they have got two vice presidents, "John Jones is not going to do anything, we do not want to give him a stock option, but Bill Smith over here, if we give him a stock option, he will really go to town."

I do not think there is any logic in assuming because you give a stock option to one person you must give it to another.

Senator GORE. I did not say that. You are the one who said it constitutes a privilege for those who received it.

Mr. DAVIDSON. I do not think anything is a privilege which is decided to bring benefit back to the grantor. It is a privilege, perhaps, Senator, to have a job. I am privileged to work for NAM. You are privileged undoubtedly to be a Senator from the State of Tennessee.

In that sense it is a privilege. But I do not think there is any special privilege, or any implication of anything bad in the privilege involved.

Senator GORE. Is it a restricted privilege?

Mr. DAVIDSON. I think restricted is purely a word of art.

Senator BENNETT. I have no questions.

Senator GORE. Senator Curtis.

Senator CURTIS. No questions.

Senator GORE. Thank you, Mr. Davidson.

The committee will recess until 2:10 p.m.

(Whereupon, at 12:30 p.m., the committee recessed, to reconvene at 2:10 p.m., the same day.)

AFTERNOON SESSION

The CHAIRMAN. The committee will come to order.

The committee today has the great pleasure of having a very old friend who was formerly in the Treasury, Dan Throop Smith.

Sit down, Mr. Smith.

STATEMENT OF DAN THROOP SMITH, BOSTON, MASS.

Mr. SMITH. Thank you, Mr. Chairman.

I am Dan Throop Smith, professor of finance, Harvard University. Needless to say, I am not representing my university or anyone at all; I am simply appearing as an individual much interested in tax legislation.

I appreciate this opportunity to appear before the committee on these hearings on S. 1625, which would remove the present provisions of the code giving capital gains treatments to future stock options.

Though there appear to be some substantial abuses under the present law, the basic economic policy which led to their adoption in 1950 is still a sound one. The relevant provisions of the law should be tightened; they should not, I believe, be repealed.

Stock options are used to permit officers and key employees to secure proprietary interests in the companies for which they work. Options were used long before income taxes became significant; they serve a real purpose quite apart from any tax advantages which they may have. Under prevailing individual income tax rates, options have become about the only method by which officers and employees who do

not already have capital can acquire significant interests in their companies.

From the standpoint of national policy, it seems desirable for officers and key employees to have personal pecuniary interests in the long-term growth of the companies for which they work. Only if this is true can the capital gains treatment of stock options be justified.

Unfortunately, the social and economic advantages of such investments, and the management attitudes which they engender, are not subject to proof or disproof and opinions on the matter may differ. But maximum long-term growth for a company requires long-term investment, research and development work, quality products, maximum long-term productivity, and competitive prices for large volume. Certainly these policies are in the national interest, and it seems desirable to have the personal advantages of the officers and employees who make the major decisions coincide with these long-term company policies. Stock ownership will produce this identity of interest. Ordinary forms of compensation may not produce this identity of interests; they may, in fact, even produce a conflict of interest, as when a profit-sharing plan causes an undue attention to short-run profits at the expense of long-term growth.

My own appraisal, Chairman and gentlemen, is that on balance the advantages to be obtained from stock options on well-conceived stock option plans are very great.

On the basis of the foregoing propositions, stock options, and special tax treatment of them, appear justified if the options really lead to long-continued proprietary interests. Their use for quick profits, by prompt sale of stock purchased under options, has no justification from the standpoint of economic policy and is an abuse of the present tax law. The grab-and-run tactics which have been adopted by some individuals should not be permitted to secure preferential tax treatment.

The policies of different companies and the attitudes of management vary considerably on this. There have been instances, of course, where stock has been held the magic 6 months, or 6 months and a day, and then disposed of. But I recall talking to the head of a rather large, though not the largest, chemical company some years ago when a stock option plan was up for consideration, and I proposed then from the company standpoint that they put in a provision that if the stock was sold within 5 years, the company should have the right to repurchase it at the original sale price to the officer.

The head of the company said, "You mean to say that you think some people would sell this stock?"

And I said, "It has happened in other companies."

He thought a while and he said, "Let's leave it just the way it is. I want to see who those people would be"—a clear indication that anyone who sold out on a grab-and-run approach would be finished so far as promotion in that company was concerned.

That, I think, is a not uncommon attitude in companies.

The obvious change in the law to make practice conform to the basic objective intended to be secured by the stock option provisions would be a substantial lengthening of the holding period for the stock. The only reservation which might be made to this change arises from the fact that in some instances a significant amount of stock can be

purchased only with borrowed funds and a long-continued personal debt may distract an executive from his best efforts. Thus, consideration might be given to a relaxation of a strict rule for relatively early sale of some stock to reduce debt.

If revisions were to be made in the tax treatment of stock options it might also be desirable to tighten the law with respect to variable price options and to successive options after a first option has been allowed to lapse. At the same time, the law should be liberalized to make options more available for small companies where their use is now often precluded because of uncertainty about the fair market price when an option is granted; a small error arising in good faith from an honest difference of opinion may now have catastrophic tax results.

If some part of the gain arising from the difference between the fair market value when the option was granted, as finally determined, and the sale price, were taxed as ordinary income, it should be possible to penalize intentional undervaluations and, at the same time, permit options to be used to help secure successor managements in some small companies where options are not now practicable. This change would facilitate the continued independent existence of some companies which are now sold to larger companies because of the impossibility of securing a new management group. But these are details beyond the scope of today's hearings.

If I may interject, however, especially because of some of the comments which were made this morning, I should like to stress what seems to me the significant point. The stock options can be especially important for small businesses at two stages:

One, in a small business first being set up, where key people have to give up the security of employment with large companies. The small new company simply cannot offer a comparable security; the only thing it can offer is a more exciting life, and the opportunity, hopefully, of a substantial capital accumulation, if options are feasible.

The problem arises, if there has not been any significant amount of sale of stock in recent times because the company is closely owned. There can then be honest differences of opinion on the value of the stock, and what is intended to be a restricted stock option offered (for instance, at 50, if it were later held that stock was then worth 60) would turn out not to qualify for the special treatment, and when it was disposed of the entire gain would be taxed as ordinary income.

The other situation where stock options can be important is when long-established family-controlled businesses are running out of management, as it were, when the older generation is retiring or dying, and there is no one in the family to take over. This is often the case, and the continued independent existence of the company depends on getting a new management group. And a new management group is not likely to go into a family-owned business unless they can get some appreciable equity interest. And it is quite understandable why they would not go in.

And likewise, the family group probably would not be likely to want a management group that did not have a personal identification with the business.

Now, it is in situations of this sort where I think some modification should be made to permit stock options to be used more effectively than they are now.

Some years ago I was part of a group that gave a good deal of consideration to this, and we were not able to come up with what seemed to be a feasible answer other than to require the Internal Revenue Service to give advance rulings on valuation, which they naturally were reluctant to do.

I think this suggestion which I have here might well take care of the problem by, as I have indicated, making a part of the spread between the purchase price and the final price taxed as ordinary income. That would serve to discourage any intentional undervaluation of the option price, but still permit an option to be entered into in good faith in small, closely controlled businesses, and carry out the functions which options are supposed to take.

My main point is a very simple one.

I respectfully urge that the natural and understandable resentment of abuses of stock options, a resentment which, I might add, I share in large measure, should not lead to repeal of the capital-gains treatment of all stock options. The preferential tax treatment is based on economic and social policy which is even more important now than it was in 1950.

As I read the record and understand the arguments that were then advanced, the decision to give preferential treatment to gains from stock options was based upon the recognition of the social and economic importance of having management identify itself in a personal way with a long-term growth in business.

With an increasing emphasis upon the importance of growth and international competition in growth rates and all that goes with it, it seems to me that those arguments are even more important now than they were then.

Restrictions to limit abuses would be desirable to make the tax law fairer. Repeal would appear to be most unfortunate.

I would hope any limitation of those abuses would be incorporated as part of a general revision which would also reduce the confiscatory rate in the top brackets. It might be a part of that.

Whatever else is done or not done, I respectfully urge that complete, outright repeal would appear to be most unfortunate.

Thank you very much.

The CHAIRMAN. Thank you very much.

The next witness is Dr. Herbert W. Robinson, CEIR, Inc.

Will you take a seat, sir, and proceed?

STATEMENT OF JAMES R. SHARP, GENERAL COUNSEL, CEIR, INC.

Mr. SHARP. Mr. Chairman and members of the committee, Dr. Robinson is in Mexico City, and his return has been delayed, and he was unable to come back and appear before this committee today.

My name is James R. Sharp. I am the general counsel and the secretary to CEIR. And Dr. Robinson has asked me to come before the committee and present his statement.

I may say, by way of introduction, that this is a young company, as you will find when I read his statement. It is a local company in

the Washington area actually located in Arlington, Va. I have been associated with this company since it started in 1954, and I am prepared to answer any questions which any member of this committee may have relative to the company, its stock option plan, and the benefits which we think the plan provides to the company.

But before doing that, in the event you do have questions, I should like to present Dr. Robinson's statement.

STATEMENT OF DR. HERBERT W. ROBINSON, PRESIDENT, CEIR, INC., AS PRESENTED BY JAMES R. SHARP, GENERAL COUNSEL

Mr. SHARP (reading):

I am the president of CEIR, Inc., formerly known as Corporation for Economic and Industrial Research. CEIR is a small but growing company which was organized in 1954 to provide a wide variety of analytical research and data-processing services utilizing the most modern electronic data-processing techniques and equipment.

Our company has historically served a large number of clients, including many other small businesses which, because of the limited size of their operations, could not afford to buy or rent even the least expensive computer nor to employ the professional personnel needed in computer programing and analysis.

CEIR is proud of its growth during the past 7 years. In 1954 it employed 32 persons and its gross income was $120,000. It now is an international company, operating research and computer centers in seven cities in the United States, and also in London and Paris. In the near future it will open additional centers in Mexico City, Tokyo, Italy, and Western Germany. CEIR now has more than 700 employees, and this year its gross income is expected to exceed $12 million. Nearly 200 companies utilized its services last year.

In my opinion, the importance of restricted stock options in making that growth possible, and in enabling CEIR to continue to expand its services, cannot be overestimated. So strongly do I believe this that I wrote Senator Gore a letter nearly 3 months ago, shortly after I read of his bill proposing repeal of the restricted stock option statute. A copy of that letter, Senator Gore's reply dated May 11, and my own second letter dated May 31 are appended to this statement as exhibits to be included in the record.

Senator Gore, in support of his bill, has suggested that if restricted stock options were abolished, all companies would be on an equal footing in the recruitment of key personnel. This is simply not true.

From the very beginning, CEIR has had to compete, not only for business, but also for trained personnel, with the several extremely large and well-established companies which have developed and manufactured virtually every computer in existence and which have also set up computer centers similar to and competitive with those which CEIR initiated in 1955.

Seven years ago, and even now, CEIR simply could not afford to pay the salaries which a large, well-established company can pay, nor can it offer the same long-range job security. CEIR could not have obtained the highly trained professional and executive talent which is essential to a service organization such as ours, on the basis of salary alone. Nor would our company have benefited from the many hours of unpaid overtime and that extra devotion to duty which our key employees have contributed to our company because they owned a stake in its success. This was made possible only because we could offset the relatively low salaries which CEIR could afford, coupled with an uncertain future in a new company, with employee stock options, and the opportunity to become owners of increasingly valuable stock in their own company if it prospered.

And many of our key employees had never before, and probably never would otherwise have had sufficient savings to purchase, outright, any substantial amount of stock in their own or any other corporation.

In a word, because it could offer restricted stock options to numerous technical and management employees, CEIR has been able to make capitalists out of each of those employees and give them a permanent stake in the future of the company they are building.

I, for one, am proud of that result. I believe that our economic system is in jeopardy if the ownership of significant amounts of corporate stock continues to be concentrated in the hands of the relatively few persons of inherited wealth or other extraordinary sources of surplus funds.

And while Senator Gore can point to some cases of executives who have added, through stock options, to their inherited holdings of stock, those instances are dwarfed by the number of men and women who have been enabled, because of the employee stock options granted to them, to become capitalists and coproprietors of a business for the first time in their lives.

For example, in our own company stock options are now held by nearly 60 employees, two-thirds of whom earn salaries of less than $15,000 per year, and only six of whom hold any office in the company.

I might interpolate in Dr. Robinson's statement to say that Dr. Robinson holds no stock options, nor do four of the principal vice presidents of the company hold any stock options. There are six officers who do hold options out of the total of eleven officers. And you will recall that I testified that the company now has over 700 employees, which means that almost 10 percent of those employees, through the means of stock options, have acquired some coproprietorship, some partnership in the business.

Eliminating employee stock options would, in fact, tend once again to promote the concentration of significant stock ownership and control in the hands of the wealthy.

From my own experience, I know that restricted stock options have not only widened the base of stock ownership among employees very significantly during the past 10 years, but have effectively reversed the earlier trend toward "professional managers" who had no long-range ownership interest in the corporation by whom they were employed—a trend which Senator Gore has rightly deplored. Only through the even greater use of employee stock options can a real stake be given to the many professional and executive employees on whom the success of most businesses, and the very survival of this country, increasingly depends in this era of technological advances.

And while I am not an expert in these matters, it seems to me that Senator Gore must also be mistaken in his estimates of the revenue loss entailed in employee stock options. To the extent that employees, under Senator Gore's proposal, would be subject to tax when they exercised their options, the employer would be entitled to an offsetting deduction at a 52 percent rate—

a point which I believe, Senator Bennett, you discussed somewhat this morning.

Taking into account that the employer gets no deduction whatsoever under present law, and that a capital gains tax of 25 percent—of, if the stock is held until death, an estate tax—is ultimately paid by each employee who exercises a restricted stock option, I cannot believe that there is any real revenue loss to the Treasury. Indeed, if I had learned of these hearings earlier than 3 days ago, I would have given the problem to one of our computers. I shall still be glad to do so if the committee wishes.

And again I should like to interpolate. I have with me a chart, which I would be glad to offer for the record, which shows the revenue loss or gain based upon the law as it now stands, relating to employee stock options and the effect on the revenue were the amendment proposed by Senator Gore to be adopted by the Congress of the United States.

Senator BENNETT. Does this refer to your own company alone, or is this a national estimate?

Mr. SHARP. No; it does not; it is merely an illustration, Senator Bennett, of the way it would work based on a certain option price with anybody, it makes no difference whom. It is based upon certain assumptions, which are shown in the left upper corner of the sheet.

It shows, in effect, that the group whom Senator Gore is most concerned about as having taken advantage of stock options in large companies, where they are highly paid and have the benefits that the Senator has spoken of otherwise; that, in fact, the Treasury, even in their case, would gain very little under such a method.

In fact, the Treasury collects more tax in most instances, as you will see from the chart, under the present system than it would otherwise.

I do not want to get into the technical aspects of it. I shall offer it as an exhibit and leave a number of copies here; and if the committee wishes more, I shall be glad to supply additional copies.

(The chart referred to follows:)

Assume: Option on 1 share
(1) Option price = $40
(2) Price at exercise = $50
(3) Sale of stock 2 years after exercise @ $100

RESTRICTED STOCK OPTIONS -
COMPARISON OF CURRENT TAXATION VS. TAXING THE GAIN UPON OPTION STOCK AND STOCK PRICE AT TIME OF EXERCISE AS ORDINARY INCOME

	A 50% Bracket		B		A 75% Bracket		B		A 70% Bracket		B	
	Current Method -NQO		Tax on Spread at Ordinary Rates at Time of Exercise		Current Method -NQO		Tax on Spread at Ordinary Rates at Time of Exercise		Current Method -NQO		Tax on Spread at Ordinary Rates at Time of Exercise	
(3) Income at time of grant		- 0 -		- 0 -		- 0 -		- 0 -		- 0 -		- 0 -
(3) Corporate deduction at time of grant		- 0 -		- 0 -		- 0 -		- 0 -		- 0 -		- 0 -
(3) Income at time of exercise ((2)-(1))		- 0 -		$50.00		- 0 -		$50.00		- 0 -		$50.00
(3) Increased Tax Revenue at time of exercise	- 0 -		$25.00		- 0 -		$37.50		- 0 -		$35.00	
(3) Corporate Deduction at time of exercise		- 0 -		50.00		- 0 -		50.00		- 0 -		50.00
(3) Decreased Tax Revenue at time of exercise (@ 50%)	- 0 -		(25.00)		- 0 -		(25.00)		- 0 -		(25.00)	
(3) Gain on sale of stock		$60.00		10.00		$60.00		10.00		$60.00		10.00
(3) Tax on Gain @ 25%	$15.00		2.50		$15.00		2.50		$15.00		2.50	
(3) Total Tax collected on option and sale ((2) + (3) + (3))	$15.00		$27.50		$15.00		$14.00		$15.00		$ 1.50	
(10) Increase or (decrease) in tax collected, by taxing spread at ordinary rates (3 - 2)			$ 7.00				$(1.00)				$(13.50)	

SAME AS ABOVE EXCEPT STOCK SOLD AT $90 TWO YEARS, THREE OF $100

(3) (3) Gain on sale of stock		$50.00		- 0 -		$50.00		- 0 -		$50.00		- 0 -
(3) (3) Tax on Gain @ 25%	$12.50		- 0 -		$12.50		- 0 -		$12.50		- 0 -	
(3) (3) Total Tax collected on option & sale ((2) + (3) + (3)(3))	$15.00		$15.00		$12.50		$1.50		$12.50		@ 1.50	
(10) (3) Increase or (decrease) in tax collected, etc. (3 - 2)			$ 7.00				$(1.00)				(@3.50)	
Increase or (decrease) per $1 of spread ((10)(3) ÷ $50)				14¢				(2¢)				(7¢)

* NOTE -- (a) If stock is not sold before optionee's death, gain is not taxed, but is includible in optionee's estate - increased estate tax results, but even at top estate tax rates loss of revenue to government would be 5.75% of spread.

(b) If optionee gives away stock, donee's effective capital gains rate may be below 25%; if optionee willstock to charity on death, the gain goes untaxed. These results are function of income tax law, unrelated to restricted stock option provisions.

Mr. SHARP. To return to Dr. Robinson's statement:

Moreover, at a time when this country needs desperately to increase its productivity and efficiency, when the President has recommended and the Ways and Means Committee has approved a flat 8-percent tax credit as an incentive to encourage additional investment in new machines, new equipment, and other business properties, let us remember that machines alone cannot create prosperity and increase productivity and employment. We also need incentives for the managers and the technicians who control the machines. We need more working capitalists in this country who, because they own stock in their company, will have an interest on its long-range welfare and will not be tempted to take the cash and let the credit go, by working as few hours as possible and demanding ever higher wages.

Indeed, I look forward to the day when CEIR will be in a position to grant restricted stock options to all its permanent employees. And I know of no other practical way to make them permanent stockholders, for few of them could afford to pay taxes on the mere receipt of stock certificates, unless they immediately turned around and sold some of that stock. And even fewer of the could afford to risk their small savings in purchasing the stock of a new and still struggling company—a company which could not retain the key employees who are responsible for its present growth, much less recruit the additional personnel necessary to its continued growth if employee stock options were abolished and it had to compete for their services with its larger competitors who can offer higher salaries, greater security, and the prestige of an old-established business connection.

Under present law, however, we can compete successfully for their services because we can offer them the opportunity to help a small company grow and to participate in the far greater increase in its stock values, if it succeeds, then the nominal increase in value of the stock of most of the larger and well-established companies, whose shares, after discounting the effect of inflation, do not change much in price from year to year.

How better than by effective incentives can we spur our people on to the greater efforts necessary to increase this Nation's productivity?

How better can we make it possible for small businesses to obtain the competent technical and management personnel they must have in order to survive and flourish in an increasingly complex business world?

How better can we broaden the base of employees' participation in the companies by whom they are employed at no net tax cost to the Government?

How better can we hope ultimately to make virtually every worker a capitalist in the true and best sense of the word?

How better can we implement Pope John's recent recommendation that "the workers should acquire shares in the firms in which they are engaged"?

Senator Gore, in advocating the repeal of the restricted stock option statute, has been concerned principally with a few isolated examples involving extremely wealthy men and extremely wealthy corporations.

And may I interpolate again.

As has been indicated by the testimony which I have given, CEIR deals in services, as I as a lawyer deal in services. It does not manufacture commodities, it deals in services. It rents computer time, it provides programing for computers, it does research and statistical analysis and mathematical work, it uses brains, it hires brains. This is the commodity which it peddles, which it sells to its customers.

Senator GORE. Do you mind if I ask a question there?

Mr. SHARP. No, Senator Gore.

Senator GORE. If you would prefer to finish first, you may do so.

Mr. SHARP. The remainder is just a couple of paragraphs, and it would be convenient to me.

Senator GORE. Go right ahead.

Mr. SHARP (reading):

Senator Gore has overlooked the many small companies throughout the United States, like CEIR, whose stock is traded on the local over-the-counter market and whose very existence would be seriously jeopardized if they were deprived of

their one real advantage in recruiting and retaining competent key employees. Scores of such companies can be found in every large center in the United States. Even in a nonindustrial city like Washington, D.C., the daily list of over-the-counter quotations of local companies numbers each day about 30. Such companies, and their number is growing, contribute immeasurably to the development of their own communities.

And so important are stock options to small business today that companies not infrequently undertake to become "listed" on their local over-the-counter market in order to simplify the grant of restricted stock options to the key personnel whose extra efforts are so vital to their continued growth and profitability. Especially is this true of the many small companies which are now being formed in medium-sized cities throughout the country to render a variety of technological services, companies which can be organized without a large capital outlay, but which cannot survive without competent professional and executive talent. Each community needs its share of that kind of talent. In years past, however, such talent has generally gravitated to large corporations in our major industrial centers because of the much greater financial rewards there available.

Small local businesses should not be deprived of their one real opportunity to attract such talent back to the smaller cities throughout this country.

In conclusion, I want to thank the committee for this opporunity to be heard on a matter of the greatest importance not only to the economic well-being of CEIR and its employees but, as well, to thousands of other business concerns and a vastly larger number of men and women who, except through the acquisition of restricted stock options, could never become part owners of the business which, by their services, they have helped build and maintain.

I shall be glad within the limits of my ability to answer any questions which may be asked.

Senator GORE. Many people are afflicted with the difficulty of amassing proprietary rights. I take it you would agree with that.

Mr. SHARP. I agree with that.

Senator GORE. I have faced such difficulties, and I dare say most Americans have.

Are you acquainted with the stock options issued by CEIR?

Mr. SHARP. Yes, I am. I drew the plans, Senator Gore.

Senator GORE. When was the first restricted stock option granted?

Mr. SHARP. There have been no stock options granted by CEIR in its 8 years of history, so far as I know—and I think I am quite correct—except restricted stock options.

A stock option plan was adopted, to the best of my recollection, in 1959. However, prior thereto——

Senator GORE. Was that the first one?

Mr. SHARP. Let me explain it.

Prior thereto and subsequent thereto, restricted stock options had been granted by the company to various employees outside the scope of the plan.

Senator GORE. Is there any particular meaning to your use of "prior thereto" and "subsequent thereto"?

Mr. SHARP. Prior to the adoption of the stock option plan, and subsequent thereto, there have been restricted stock options granted by the company outside the scope of the plan.

Senator GORE. Tell me when the first restricted stock option was granted, please.

Mr. SHARP. Let me see if I have the date.

I do not have the dates, but to the best of my recollection, it would be about 1955 or 1956, shortly after the company came into being.

Senator GORE. At what price are the options granted?

Mr. SHARP. In all instances the options under the CEIR plan have been granted at 95 percent of the market value on the day of grant.

Senator GORE. Unfortunately, I am not acquainted with the stock of CEIR. Can you tell me the value of the stock at the time the option was granted?

Mr. SHARP. I fear I cannot do so. The stock, sir, has had a phenomenal growth.

In 1959 there was a public issue, and I would say the stock is many, many times the value now of the original public issue, because of the company's phenomenal growth, which we feel has resulted from the fact that we have on board in this company people who would not have come aboard were it not for their ability to acquire a stake in it.

Senator GORE. I notice you say that two-thirds of those holding restricted stock options have salaries of less than $15,000 per year.

Mr. SHARP. That is correct, sir.

Senator GORE. Then you are using restricted stock options as the primary incentive to attract the people you desire?

Mr. SHARP. I would say yes, and add to it this: We are also utilizing them to retain those who have shown ability, after having joined the staff, who have in this very specialized, technological field of computer programing and operation, and statistical and mathematical research, shown outstanding ability, and who constantly have flaunted in their faces opportunities for employment by many other companies.

Senator GORE. Now, with the low level of salaries which you described for CEIR, and the reliance, principal reliance upon the stock option to attract quality employees and officials, you are thereby substituting the restricted stock option appeal for the more traditional appeal of salaries?

Senator BENNETT. May I ask a question at this point before he answers it?

Senator GORE. Yes, sir.

Senator BENNETT. Are these people who are being paid $15,000 a year or less doing work for which they could get double the money anywhere else? By this example are you telling us that you have broadened your plan to reach down to people who, under many other corporate plans, because they earn $15,000 or less, would not be reached by stock options?

Mr. SHARP. Well, I will answer both questions if I may, simultaneously. I don't want to set CEIR apart from many, many thousands of other small businesses in this country who are faced with the same problem we are, but in a little different emphasis, perhaps, one way or the other.

Senator GORE. Please understand, I am not trying to set it apart. The committee is holding this hearing for the purpose of gaining information and the purpose of affording people who desire to testify an opportunity to do so. You have come representing your company and have stated the problem of your company, and have expressed the view that the enactment of the bill on which the hearing is held would adversely affect your company. Therefore, it seems entirely proper to inquire into the nature of the options granted by CEIR, not by way of indictment, but by way of information, for the purpose of gaining information.

Mr. SHARP. I fully agree with you.

I would like, however, to continue, if the Senator would permit, to answer the question in an overall manner.

Senator GORE. Yes.

But I did not want any inference to be drawn from my question or the question of Senator Bennett that we wanted to set CEIR apart. It has been used as an example before the committee, and, therefore, we would like to explore it.

Mr. SHARP. Senator Gore and Senator Bennett, may I say that, as both of you well know, and as this committee well knows, since 1940, particularly, since the Second World War, the technological advances which have been made in this country and the need for scientific brains, for mathematicians, for well educated, devoted people who can work in this space age, who can work in the computer age, who can operate and utilize the modern techniques of analysis, of getting the answers which business and which government and private institutions need, is tremendous.

That is the reason I said, Senator Gore, that I didn't want to separate CEIR apart and say that this is a special problem, because I don't believe that, and certainly Dr. Robinson doesn't believe that.

We have contacts day by day with literally hundreds of companies throughout the United States, in the State of Tennessee and every State in the country who are competing for employees, of a type almost as rare as satellites. You can pick up, for instance, the Los Angeles papers and look at the 25 pages of advertising for technological personnel, you can pick up the Washington papers or the New York papers, whatever you wish. And it is not a problem relating just to CEIR; technological advances in this country have proceeded at such a rate that it is beyond our ability to produce the people necessary to man the facilities, let us say.

Senator GORE. I think we understand that.

Now, in answer to my question, and the related question of Senator Bennett.

Mr. SHARP. The answer is that basically we have utilized stock options, (1) to attract to the company's employment people who otherwise we would not have been able to get because the larger companies—I think IBM is an illustration, and RCA—the large computer manufacturers in which this science of computing has been developed, have a near monopoly on qualified personnel, they are well established, their stock is well established, they are old companies, and they have vast employee benefits.

We are, like thousands of other companies, a small company attempting to creep up and to get into what has been centralized in the hands of relatively few, because it has been developed by them. Now, this is not only true of computing but many other sciences, the space technology, and whatnot. But we have utilized options because CEIR is a young company which we believe is going places; we can't pay the salaries that IBM can pay, we can't pay the salaries that RCA can pay, we can't pay the salaries that our competitors, if you wish to call them that, can pay. And in many cases, even if we offered the same salary, the individual would still prefer to work for a large well-established company because of the added prestige and security.

The Senator made a point, for instance, with respect to the question of antitrust, and wouldn't it be a good idea that people should be able to go out and establish their own companies. I agree with you, sir.

But by this plan of stock options, people are able to acquire ample capital if they wish to do so, and it would permit them to have the capital available to do so.

Now, getting back to the question, we utilize options, as I have stated, to attract people of the caliber and the talent we must have to do the jobs we have set out to do in a highly technological field.

No. 2, we hire people that apparently don't have any outstanding record or who are just out of school. For instance, a programer normally must have his masters degree in mathematics. So we hire a man like that, without knowing what his real capabilities are.

You may find not only that he has great technical capabilities, but that he also has outstanding administrative abilities. He can in the course——

Senator GORE. Do you pay this new employee by salary or by stock option?

Mr. SHARP. In most instances new employees, with the exception of perhaps 8 or 10 of the 60 persons who now hold stock options, gained them after they came aboard and when their abilities were realized and they had vast opportunities to go elsewhere, and only by obtaining a stake in the company would they remain.

May I ask the Senator, have I answered your question or not, sir?

Senator BENNETT. Not quite.

Let me restate it briefly and then I will find out.

Here is a man who is earning $12,000 a year. When you hire him, do you say, "We can only pay you $12,000, and we will give you a stock option," or do you hire him at $12,000, and then, discovering that he is worth more, do you give him a stock option to keep him?

Is the stock option a proselytizing device that you bring out of the bag when you are setting your salary for your man, or is it something that you use after you have made a determination whether this man is the man you want to keep?

Mr. SHARP. Senator, only in rare instances as I have indicated, have we ever used it as what you call a proselytizing device, I would say six, eight, maybe only three or four. I have the entire list before me, but I would have to look it over.

In the majority of cases it is used in order to retain the services of an individual who has been hired for $5,000 or $6,000 or $7,000, or whatever it may be, and who has shown that he has the capabilities to help make CEIR what the managements wants to make CEIR which is an outstanding technological expert in these fields. And it tells the people when it brings them on board, "We have a plan under which, if you show that you have got on the ball what CEIR needs, you will be recognized eventually and given a chance to invest in CEIR."

And I think that is the answer to your question.

Yes, Senator Gore?

Senator GORE. Will you supply for the record the details of each restricted stock option plan, the person to whom it was granted, when it was granted, the fair market value of the stock of CEIR at the time the option was granted, the amount of option which each person has exercised, the value of the stock at the time the option was exercised, how much of the stock each employee still holds, the current value of CEIR stock, and the salary of each person from the beginning to the present who has received a stock option?

Mr. SHARP. May I make a couple of comments on that?

No. 1, obviously the amount of the options make sense only in the light of the number of shares then outstanding. It is increased by reason of financing and other reasons, obviously.

Senator GORE. You can supply the amount of stock outstanding——

Mr. SHARP. In percentages as to number outstanding at any particular time, otherwise it might not make sense.

No. 2, as to the persons, I have the feeling that—I don't exactly want—I can tell you the capacity, but for us to put on the record their salaries and their identities and the jobs they have, I think that would be confidential information which should not be——

Senator GORE. I did not ask for salaries, but for the operation of the corporation——

Senator BENNETT. Would you be content to have these people identified as A, B, C, and D, giving the date on which the option was expended?

Senator GORE. I think that would be sufficient. The purpose here is information. You have come and given us an example. Frankly, I think it is heavily in support of my point of view, because from the information you have given it would appear that you are substituting this new form of tax avoidance compensation for the traditional method of paying salaries.

And if that is true, then the record must show it.

If it is not true, then the information which you supply here will reveal that. It may be that I have drawn erroneous conclusions. Let the record show the facts, and then all of us can draw, I hope, correct conclusions.

Will you supply this information and designate the people as A, B, C, D, et cetera?

Mr. SHARP. I would be glad to do that.

However, I may say that I think the Senator is mistaking the import of my testimony on the position I take on stock options——

Senator GORE. I didn't mean to imply that you intended to support it.

Mr. SHARP. I didn't mean that at all.

May I say this: No. 1, we do not substitute it for pay. We cannot pay those people like IBM can, we cannot provide the beautiful offices and accoutrements like IBM.

Senator GORE. If you supply the information, we can draw our own conclusions.

Mr. SHARP. All right. But it is not a substitute for pay. We can't pay as they pay.

No. 2, I would like the Senator to know at this time that our stock options provide roughly this. The employee doesn't get the right to exercise any of them for a period of 2 years after he gets the piece of paper which says he has an option.

The piece of paper might say he has an option on 50 shares. His right to actually exercise the option to purchase those 50 shares at 95 percent of the fair market value on the date of issuance accrues over the following 4 years at the rate of 25 percent the first year; that is, 2 years with nothing exercisable, the third year 25 percent, the fourth year up to 50 percent, the fifth year up to 75 percent, and beginning in the sixth year 100 percent.

Now, this is a device obviously to do exactly what a number of the witnesses testified this morning was important, to retain people on the payroll.

They cannot come in and get their stock immediately and leave the company after a year or two.

Senator GORE. You began to describe it correctly as a device.

Mr. SHARP. Well, if you wish to put it that way——

Senator GORE. Well, you put it that way.

Mr. SHARP. It is a device to keep good employees in a small business, which I am sure the Senator will agree is vital to the economy of this country.

Senator GORE. Thank you very much.

And the staff of the committee will supply to you a transcript of the record in order that you may supply to the committee answers to its questions.

(The information referred to is to be furnished by Mr. Sharp.)

(The following letters were appended to Dr. Robinson's statement as exhibits.)

MAY 1, 1961.

Hon. ALBERT GORE,
U.S. Senate, Washington, D.C.

DEAR SENATOR GORE: I was interested to read of your bill to abolish corporate restricted stock options and I am most anxious to acquaint you of one aspect of such a measure of which you may not be aware.

If you succeed in abolishing restricted stock options you will help the big corporations and seriously injure small business. This I know from my experience of the last 7 years in trying to build up a new business against the competition of large corporations.

You should realize that in today's world the greatest problem of a company like ours is to recruit capable technical talent in the midst of great scarcity. How can we compete against large companies which can offer all kinds of fringe benefit plans, such as retirement, generous training programs, bonuses, fine buildings, and many other favorable features, let alone the permanence and security of employment they offer? The answer is that in small business we have to find some other attraction which will enable a fine technician or engineer to undertake the 15 hours a day of hard slugging in modest circumstances at low salary, and with a sizable risk that the company will go out of business and that he will be labeled a failure, to take a position with us and justify this to himself and his family. The attraction is to offer him stock options which give him the prospect of reaping a rich reward for his efforts if the company succeeds. Because we are small, the percentage increase in our stock can be much more dramatic than in the case of the big companies (although IBM is probably one exception) and this neutralizes their other advantages.

The stock option is also small businesses' only way to compete for staff with the "nonprofit" corporations, being encouraged by Defense Department policies, who offer an atmosphere to technical people of high pay, little work, and a nice restful atmosphere. From the country's point of view this means we get only 80 percent performance out of our scarce talents.

I think a point easily overlooked is that there is absolutely no guarantee that the price of stock in a particular company will in fact increase. Thus, an employee who is tied up for perhaps 5 years on a stock option plan may work an 80-hour week and still at the end of the period find that he has absolutely nothing if the company has not succeeded.

To my mind, if you believe in the American way of life, in the idea that a man should be able to start from nothing and by a dint of hard work, ability, and ingenuity, create a fortune and an estate, you cannot help but agree that the stock option is one of the most satisfactory means available in our present

society for accomplishing such a result. It makes this possible for the man with no capacity but who has the scarce talents of which we in America are still in direct need. It seems to me that if you take away the initiatives so that people can achieve only a little more than the next man despite huge differences in ability and the amount of effort undertaken, we will get what we deserve—a nation of "9 a.m. to 5 p.m." guys looking at the clock and totally lacking in initiative, drive, and energy. Under such conditions we would probably deserve to go under to the Russians. My own philosophy is that we must reward effort and find some way to inspire every one of us to greater and greater efforts for the country and for the economy. Every means that is made available by government policies to yield this result will pay our country many times over. What we may lose in taxes through stock options will be gained in much greater measure through far greater national income which can be taxed through the normal channels.

Sincerely yours,

HERBERT W. ROBINSON, *President.*

U.S. SENATE,
COMMITTEE ON FOREIGN RELATIONS,
May 11, 1961.

Mr. HERBERT W. ROBINSON,
President, CEIR, Arlington, Va.

DEAR MR. ROBINSON: Thank you very much for your letter of May 1 concerning restricted stock options. I am sorry you do not agree with my position in this matter but your views are most welcome and I shall certainly keep them in mind.

I must disagree completely with your position concerning small business. The small business can no more compete with the large and well-established corporation on stock options than it can with respect to retirement plans, bonuses or others forms of compensation.

Your interest in this matter is appreciated.

Sincerely yours,

ALBERT GORE.

MAY 31, 1961.

Hon. ALBERT GORE,
U.S. Senate, Washington, D.C.

DEAR SENATOR GORE: Thank you for your letter dated May 11, 1961. In connection with the question of whether stock options in small businesses can attract top-level personnel to the smaller companies, the following are some figures showing an index number of over-the-counter industrial stock compiled by the National Quotation Bureau of New York compared with the Dow-Jones Industrial Index:

	Over-the-counter industrial stock	Dow-Jones Industrial Index
Dec. 31, 1951	108.88	679.36
May 17, 1961	125.11	706.48
Increase in price (percent)	+15	+5½

I think you will agree that this recent experience in the stock markets shows the attraction of the smaller businesses as regards stock options. Moreover, I am sure that if one compared the possibilities of many hundreds of percentage increase, the frequency of such very large gains to the option holder is much greater in the case of the small company than in the large. This follows from the fact that it is so much more difficult for the large company to multiply many times over when its sales are already at a very large volume.

I hope these few comments will assist you further in your work on this subject.

Sincerely yours,

HERBERT W. ROBINSON, *President.*

Senator GORE. The next witness is Mr. A. Wilfred May.

TESTIMONY OF A. WILFRED MAY, COMMERCIAL AND FINANCIAL CHRONICLE, NEW YORK, N.Y.

Mr. MAY. First, I would like to emphasize the fact that the views I shall express are strictly my own, and the publication with which I am associated carries no responsibility therefor. In fact, we are running in an early issue an article by Mr. Ware, who has a position entirely opposite to my own, which shows the objectivity of our publication.

There are two essential divisions in my statement. Part 1 is designed to get a reorientation on the very fundamentals of the operation of a stock option. And part 2 would call attention to something that is overlooked in most discussion, and has been almost completely overlooked in today's proceedings. I have in mind the wide implications of the so-called "reset" of the price via change of the contract price after it has been established.

I might add that even where the "reset," the change in the contract, has been treated in writing and speaking, I think the implications have not been fully realized, particularly the angle, the phase, that is germane to the consideration of this bill; and that is the whole question of the tax on the gains from options.

Now, on part I, covering the essentials of the actual operations of stock options, as presently constituted, our stock option system's workings are completely irrelevant to its constructive and laudable aims. The option system is motivated by the major premise that the company's profitability resulting from management achievement as reflected in its stock's market price. (Typically, only yesterday on the Senate floor, Senator Curtis quoted Henry Ford's comments at his company's 1960 annual meeting recommending the adoption of a new stock option plan: "* * * With stock options your management is rewarded in direct proportion to the company's profitability. If the value of the stock does not go up, the options are worthless. The stock option is one of the few means of enabling the manager to participate in the success of the business achieved through his efforts. No other plan gives management employees as extraordinary an incentive to make the company profitable.") In lieu of providing managerial incentive via rewarding the hard-working executive's achievements as measured by a rise in the intrinsic value of the company's stock, actually the optioning company has involved the optionee in a playing-the-market operation. (Incidentally, loading-of-the-dice, which I am going to discuss more fully here a bit later on.)

Now, this is true mainly because the stock's fluctuating market price which determines the optionee's reward, does not register changes in the stock's value—no matter who has been responsible therefor.

Basically contributing to the market's pricing, of the company's stock is, of course, the value factor of the earnings. But far more effective determinants are market conditions, ranging all the way from money rates to all important investor psychology. This divergence of market price fluctuations from earnings is indisputably evidenced

by the unceasing and violent volatility in the price-earningss ratios of all stocks—the price earnings ratio being the earnings divided into the price. In other words, if a stock earns $5 a share and it sells for $40, the price earnings ratio, and the multiplier, are 8.

Actually, these fluctuations are determined not so much by the earnings as by the size of the mutiplier, as I have just explained, by which they are capitalized by the stock market community and not by individual company factors.

Now, here are some illustrations of that.

From 1939 to 1949, a 10-year period, the earnings per share on Standard & Poor's 500-stock composite index rose by 196 percent, but these share prices gained only 34 percent. Conversely, during the following decade, while the earnings showed a net rise of 42 percent, the share prices, which, of course, registered their capitalization by the market, gained a full 270 percent.

I take the liberty of interpolating here that Mr. Ware, when he saw my memorandum this morning, said, "Oh, you can show anything you want by selecting your stocks." But here we have the 500 stocks of Standard & Poor's index, and also other indexes and examples which I am including in my statement.

The determination of market price by investors' mood or psychology, rather than by the earnings, is again demonstrated by the course of the price-earnings ratios on Moody's 125 industrials, shown in the following table. As we see, there have been successive variations, up and down, in the ratio ranging from a low of 6—that is stocks selling at 6 times their earnings on the average—in 1950, to 21 times at the present time.

Year:	Price-earnings ratio	Year—Continued	Price-earnings ratio
1947	8.7	1953	9.9
1950	6.8	1954	11.4
1951	9.6	1960	18.9
1952	10.5	1961 (estimated)	21.0

This again shows the varying capitalization of value in the market, the divergence of market price from the enterprise's business factors; whereas the whole basis and major premise of the option-rewarding system is that managerial success will be carried through to the market price.

And that is why what I am saying is an attack on or reexamination of the whole basic technique of the option reward.

Again, 50 utility common stocks, Standard & Poor's index sold at 11 times their earnings in 1950, at 15 times at the end of 1952, down to 13 times their earnings in mid-1953, and up to over 18 times in 1959.

Now, here is a very important set of figures. In connection with the Dow-Jones industrial average—and this is not a few stocks, this applies to the entire index—the 30 stocks in the Dow-Jones index were capitalized by an 8.4 multiplier in 1950. In 1960 the multiplier was 18.9 in price over the decade which variation had nothing to do with executives' ability, achievement, hard work, or the other incentive objectives we have been hearing about the last several hours.

Strikingly demonstrating the volatility in the market multipliers applied to earnings—and get this one, please—during that entire interval were the rises in market price, in the face of reduced earnings, in the following individual Dow-Jones issues.

Stock	Earnings per share		Price		Price-earnings ratio	
	1950	1960	1950	1960	1950	1960
American Can	$3.17	$2.06	$23	$36	7	17
Bethlehem Steel	3.04	2.52	12	30	4	16
International Paper	1.80	1.74	13	31	7	18
Johns Manaville	3.61	3.12	24	57	7	18
United Aircraft	2.07	1.95	16	37	8	19
Westinghouse	2.66	2.22	17	49	6	21

And there you see six issues in the Dow Jones Industrial Average where the earnings were declining, were lower in 1960 than they were in 1950—but the prices were much higher.

Senator GORE. Mr. May, I must say that this is something that has puzzled me a great deal.

Mr. MAY. I hope you are not now all the more puzzled.

It is very difficult to make this clear.

Senator GORE. I am not referring now, in this comment, specifically to the relationship of stock options to the price-earnings ratio.

But it has been amazing to me how the ratio between earnings and price has become so disproportionate, as you set out in these tables here.

Take American Can. The ratio was 7 in 1950 and 17 in 1960. Is that a healthy thing?

Mr. MAY. I know you have other speakers following, and you have to catch a plane, and even if the plane didn't leave until tomorrow we couldn't dispose of all the reasons for the stock market's irrational fluctuations. I am writing a book titled "Freud Over Wall Street" (pardon the plug). Freud was the great psychoanalyst, as you know, which indicates the trend of my own thinking on the question. But I won't take the time to expand on my basic conviction that stock market understanding requires a psychiatrist, not an economist.

Senator GORE. I will make this deal with you. I will at least quote one paragraph on the floor of the Senate.

Mr. MAY. Right.

Here is another conclusion—and I think if Senator Bennett were still here, or Senator Byrd, they would try to question this. But the facts are indisputable as to these haphazard variations in the multiplier and thus in the market's appraisal of earnings.

Now, I say it is an indisputable conclusion, surely that stock market price changes are not attributable to the efforts or achievements of the option-holding executive.

And I would like to stand on that until hell freezes over.

A corollary conclusion of that would be that the incentive reward should be geared directly to earnings, and/or other criteria of business volume, and not to their so persistently haphazard capitalization by the stock market, as they are now.

Senator GORE. Do you think it is now geared partly to speculation and partly to the vagaries of the marketplace, but it is wholly unrelated to the dividends received by the ordinary stockholders?

Mr. MAY. Well, the facts are indisputable. As far as relating the proportion of one to the other: frankly, I spent about an hour the night before last discussing how to word that conclusion with my son, who is with a management consulting firm. And we agreed on this; I had suggested that not the earnings but the market vagaries, as you say, control the market price. But we compromised on stating that "at least as important" as the earnings are the market vagaries in setting the price. While this sounds like a radical assertion.

But the proof is indisputable as evidenced by all the indexes and averages I have shown—and not merely by small samples.

Now, a corollary of that conclusion would be that from the corporate point of view, this playing of the market, this gearing of management incentives to the market, hurts the corporation in an ancillary sort of way in tending to make the management more market conscious in various ways in whipping up public relations techniques.

There are hundreds of my good friends in public relations firms around New York who are engaged in creating favorable market atmosphere for their clients' stocks. There are various conflicts that could come up through market over-consciousness by management. For example many, I know several companies who while they have options outstanding, are buying in their stock on the market.

That may be justified, or it may not be. But there is a potential conflict of interest there. The decision of management whether to buy this stock on the open market might possibly in some cases be determined by the self-interest of the optionees.

Now, the other area I want to cover embraces the implications of the reset, which is the technical term for change in the contract, reducing the option price in favor of the optionees, if and after the stock has declined in market price.

I have called this in my statement a "heads I win and tails you lose" process.

This has been mentioned before, but I submit that the wide implications taxwise have been overlooked.

The "resetting" privilege, that is the ex post facto lowering of the option's contract price subsequent to the security's market decline, has the broadest implications. This is so not only in compounding the above-depicted market-playing role, but also vis-a-vis our whole tax structure and tax policy.

Such change-in-the-deal is specifically permitted by the statute and I am glad to emphasize that.

Prior to a 1954 amendment to the Internal Revenue Code, an option holder would have lost the right to the tax treatment accorded under the Code to restricted stock options, if the option price were reduced during the term of the option. That logical restriction existed before 1954.

In 1954, however, the Code was amended to permit such a reduction, without the option holders' sacrificing such tax treatment, if the fair market value of the stock covered by the option had declined by an average of more than 20 percent over the period of at least 1 year.

Typically, I want to give you some examples—American & Foreign Power recently took advantage of this "resetting" privilege. Thirty-five options had been issued from 1955 to 1959, at prices (100 percent of the concurrent market), ranging from 11½ to 17⅜. The directors thereafter, on May 28, last, reduced, with shareholder approval, via proxy, them to the lower market price as of the day of the price modification. On May 15th last, the market price was $10.50 and on May 25th, $11.

Thus if the privilege of resetting had taken place on those days the contract would have been reduced from anywhere from, say, an average of 15 to 10½ and 11 or 30–27 percent.

This was the management's reasoning:

> The board of directors believes that the effectiveness of the plan authorized in 1955 in achieving its purpose is materially impaired when current market prices of the stock are substantially below the prices at which most of the outstanding options were granted.

Public utility holding companies under the jurisdiction of the 1935 act must get the SEC's option-issuing permission in each case, because of the Commission's statutory obligation thereunder to approve—I underline the word "approve"—new issues—in contrast to its more limited jurisdiction under the Securities Act of 1933 which is confined to insuring disclosure.

The 1933 so-called New Securities Act regulates issuance of new securities, except in the utilities field, and also excepting the investment companies field, where incidentally, management options, are barred. (By the Investment Company Act of 1940, sec. 18.)

Two utility company cases of "resetting" the option price have recently occurred in Middle South Utilities' application for permission to reduce the price was approved by the SEC. While the privilege was subsequently dropped by the management, it can be used in the future.

The Ohio Edison Co. likewise secured he SEC's approval, on March 16 last, to lower the outstanding option price, and has retained the privilege.

Presumably, the number of such contract revisions will substantially increase during a future change to a bear market from the recent bullish era wherein most of these revisions have taken place. You, Senator Gore, mentioned one in your recent speech on options before the Senate, the *Alcoa* case.

What is going to happen in a bear market?

One-way contract price juggling is going to become all the more frequent.

Incidentally, this witness has not heard of any provision or instance of "resetting" when the stock has risen instead of fallen. In other words, the long-term routine constitutes a one-way subsidy, heads you win and tails I lose.

Senator GORE. If the board of directors wished to place the interest of the ordinary stockholder of the corporation first, then it seems to me we should find at least one example of resetting upward.

Mr. MAY. I heartily agree.

Here are some important conclusions:

The reset practice policy, freely permitted by the statute highlights the optionee executive's certainty of receiving additional compensa-

tion. (Incidentally, it also usually assures the other stockholders guarantee of some dilution of his equity. They are not diluted at 18, with the price reduced to 15, they will be diluted at 15.)

But the important thing, I want to state there—and I would like to bring it out at this point—is that it assures the executives certainty of receiving additional compensation, taking it out of the class of a conditional option arrangement under any semantics, and putting it into the category of guaranteed compensation, risk-less compensation.

Senator GORE. Instead of it being, with the reset practice, an option, it tends to become, not an option, but an assurance?

Mr. MAY. Backing up your statement, and contradicting the representation of the preceding witness, it is assured compensation thinly disguised as a conditional option.

The reset privilege which guarantees the recipient a benefit no matter what happens, whether the stock goes up or down, carries a particularly crucial implication on accompanying tax policy.

Calling such assured and riskless compensation a capital gain completely contradicts the thesis that the latter are fortuitous and risky; which certainly motivates their favored tax treatment in this country, and tax exemption in most other nations.

And I would like to add in here something I think that was overlooked today, that one of the benefits or giving the optionee capital gains status is, along with the 25 percent rate ceiling, exemption of the recipient from all tax at death, when his capital gains are exempt from taxes at death.

Hence, so long as options are used, either the reset notice should be eliminated, or the profits therefrom subjected to taxes as ordinary income, with a reduction of the present confiscatory surtax rates.

In any event, in line with our demonstrations in both sections 1 and 2 above, the option should rather be replaced by a technique of getting outright share ownership to the corporate executive, either by bonus routine or other as additional salary-type compensation.

I think most of the aims I have heard this morning and previously would be thus satisfied. Talking about a stock interest for getting the executive to work harder and having the interests of the corporation at heart, and so on; that could just as well be attained without the tax gimmick, by profit sharing or some bonus system in lieu of the extra salary.

Maybe I am sticking my neck out, I haven't thought it through. But in the cases of the preceding witness, instead of giving an executive $15,000 a year plus an option arrangement with this unfair tax arrangement, why not give him $15,000 a year plus some stated share in the increased earnings, when, as, and if?

This would accomplish both the incentive objective and reduce the abuse of divergence of interest between the management controllers and the stockholder-owners.

Thank you very much.

Senator GORE. Mr. May, you have given a very erudite and helpful statement. Thank you.

Mr. MAY. Senator, that is an awful thing to say—"erudite." The kiss of death.

Senator GORE. Well, I certainly did not so intend it. I meant it to be highly complimentary, sir.

Mr. MAY. I realize that. I was only jesting. Thank you very much.

Senator GORE. Miss Adele Stanton.

Miss STANTON. This may not be erudite, but it is a woman's opinion.

Senator GORE. Well, a woman's opinion is always superior.

Miss STANTON. Thank you.

STATEMENT OF MISS ADELE L. STANTON, BROOKLYN, N.Y.

Miss STANTON. Mr. Senator, my name is Adele Stanton, a native New Yorker, and a retired Wall Street secretary. Dividends are my only income. My securities were purchased over a long period of years to be held as conservative investments in American free enterprise. I am not an unfamiliar figure at stockholder meetings. My prime interest is in the performance of top management. I ask pertinent questions and without exception—the bigger the man at the helm of an organization, the better the answers he gives me. The quarterly or semiannual reports will soon convey to the most ignorant of us stockholders, if the management is slipping and there is no law that compels you to hold the stock.

After listening intenly to the testimony given here yesterday, it occurred to me that the sole purpose of bill S. 1625 is to legislate honesty. Back in the 1920's someone asked our President what he thought of sin and he said "I'm agin it." So am I. And, if there is anything in our laws that has caused more sin than our tax structure, name it. Yesterday someone said, "In the good old days men had the guts to put their own money to start a business." True and in the good old days there was no tax problem.

Stock options, we were told yesterday, do not serve their purpose for it does not anchor a top executive to his job. I believe a specific instance was given of a keyman switching to another organization. The answer to that one is—such popularity must have been deserved. Are we to understand that because a man accepts a stock option from a company employing him—he is then supposed to be bound to work for that company until he reaches retirement age? That sounds to me something like penal servitude. Would not such a requirement deprive the individual of the freedom of choice? Would such a proposal be constitutional? I rather suspect the present Supreme Court might say so but I sometimes wonder if the members of that Court really know very much about our Constitution.

Here I would just like to add there was a comment this morning about that article on the Ford Co. back when they facing disaster—they approached a group of men, who were their best bet to save the company. They offered them a stake if they made good. Today, we all know there are thousands on the Ford payroll in America, England, Germany. Just before I left New York on Tuesday, one of our most conservative brokerage firms offered Ford stock as a very good purchase. I think those Ford men earned their stake.

America can outproduce any country or combination of countries in the world today. American free enterprise produced everything required for the United States and its allies to win two global wars. This morning there was the miracle that many of us were privileged to see—that was shooting our second man, launching him into space

safely. That was made possible by keymen in American technology, who, to my mind, are entitled to special financial protection. They should not be harassed by those who are less qualified, seeking laws to deprive them of their just due.

I do not deny that this stock option plan is liable to abuse by the always to be found unscrupulous few. But, is this the time, when we face the threats of an atomic war, to condemn all for the misdemeanors of a few? I have just returned from 2 years residence on the Soviet border in Germany. Our boys stationed over there keep their eyes on a little red telephone. We, at home, better keep our eyes on our big producers and stop haggling.

Gentlemen—let's forget this S. 1625.

Thank you very much.

Senator GORE. Thank you very much. I still say a woman's opinion is superior.

Miss STANTON. Thank you very much.

Senator GORE. Mr. Smith.

STATEMENT OF JESSE R. SMITH, ARMSTRONG CORK CO.

Mr. SMITH. My name is Jesse R. Smith. I represent Armstrong Cork Co. We appreciate the opportunity of making this statement. We ask leave to file the attached memorandum.

Senator GORE. Without objection, it is so ordered.

(The memorandum referred to is as follows:)

ARMSTRONG CORK CO.—IN DEFENSE OF RESTRICTED STOCK OPTION PLANS

JULY 20, 1961.

1. How to retain and reenforce the basic business ownership incentive in our capitalistic society is a very perplexing problem, especially since this incentive has provided the spark of initiative and risktaking underlying our record of national growth and greatness.

During the early days of the Nation's economic development, enterprises were almost entirely owner managed. Management compensation was no problem then because the owners had a strong incentive—direct compensation plus increased value of their ownership interest—to use all of their ingenuity, initiative, vision, courage, and leadership to make their businesses successful. However, as business enterprises expanded and corporations replaced many proprietorships and partnerships, the owner-manager has tended to disappear, and his counterpart today is the salaried executive or professional manager. Stock options have done more to promote ownership incentive in American industry than anything else in recent years.

2. Restricted stock option plans are not a tax loophole, but a conscious effort by the Congress to strengthen financial incentives in our system at a time when the Communist bloc is adopting more and more financial incentives to stimulate their key personnel to make still greater contributions to their worldwide conquest effort. Hence, to eliminate options is to embark on a policy destined to weaken American incentive at a time when the Communists are strengthening theirs.

3. Objections to stock option plans arise only when the current market price of the stock rises noticeably above the original option price, which is precisely the condition which the entire option program seeks to create as an incentive to management optionees and shareholders generally. Any increase in market value of stock, of course, is the same for stock which has been purchased on the open market as that which has been bought under option. Hence, all stockholders benefit the same as optionees when the price of the stock advances, and not just optionees.

Optionees under restricted plans cannot buy stock at prices substantially below the actual price on the market the day their option was granted. The

stock must rise above the option price before there can be any gain to the option holder by sale of the stock, and the optionee typically cannot exercise his option earlier than 1 year after it is granted. There is no opportunity for "overnight profit."

4. Private managements to an overwhelming degree determine the extent of national economic growth. Long experience has proven that these same managements in turn perform most effectively when they have clear-cut incentives leading to tangible rewards for their successful efforts.

Confiscatory income tax rates have made it increasingly difficult in real terms to compensate principal officers and key employees in accordance with their responsibilities and contributions. Generally rising wages and salaries have had the effect of severely narrowing the spread of after-tax income between individuals in higher and lower range levels of responsibility. Stock options have helped in part to preserve the incentive differential for many individuals making key management decisions in our society.

5. The loss of revenue to the Government from capital gains—instead of ordinary income—tax treatment of stock options is really quite insignificant when compared with the enlarged general tax revenue base which typically results from growing profitable businesses. Moreover, to the extent that the market price of optioned stock advances because of the efforts of optionees, there is an identical rise in the capital gains tax liabilities of the more numerous other stockholders holding the same securities.

6. Claims that stock options tend to dilute existing stockholder interests really have little substance because the number of option shares is typically so few absolutely and relatively as to constitute little change in total shares outstanding. More important, the new shares are issued to management personnel and commonly held as a major share of life savings. In other words, existing shareholders are aided by having new stockholders added who are active and directly contributing to the company's profits.

7. Under the regulations of the Securities and Exchange Commission, optionees and all other stockholders are protected against secret management actions by the requirement that annual registration statements be filed by the company granting such options. Shares of optioned stock are limited by stockholder approval, and when exhausted can be replenished only by further stockholder approval.

8. While there have been some abuses of stock options, such abuses should be corrected and not permitted to destroy the concept of stock options as an incentive to management in the interest of stockholders and the Nation generally.

The principal abuses of restricted stock option plans could be eliminated without impairing the option principle if the following limitations were adopted:

(*a*) All options to be established at prices 100 percent of the market price on the day granted.

(*b*) Once established, prices of outstanding options not to be subject to any downward revision before expiration.

(*c*) Maximum number of shares to be optioned to any one individual during his entire tenure of employment, to be limited to a dollar value, at the option prices applying, not in excess of four times his annual compensation on the dates the options are granted.

Mr. SMITH. I think it will only take me about 6 minutes to read this statement, Senator, and probably if we go through it, it may answer some of the questions you may have.

Since 1952 when our stock option plan went into effect, we in Armstrong Cork Co. have found it has provided a means to enable key employees to acquire an ownership in the company. Many authorities, including Members of the Congress, recognize that progressive income taxes make it extremely difficult for employees to acquire more than a very limited ownership in a corporation. This was true in Armstrong prior to the adoption of the plan.

We believe that the restricted stock option is a powerful incentive for officers and key employees to do the best job they possibly can to further the corporate interests. We believe it has worked well in our case.

Since the adoption of the plan by the stockholders in April 1952, the company has granted seven groups of options thereunder to officers and key employees. In each case the option price was at least 95 percent of the closing market price on the date of granting the options, as appears from the following table which sets forth the years the options were granted, the number of employees, the price per share for each group of options, the closing market price on the date of grant on the New York Stock Exchange, adjusted, in the case of the three earliest groups, for the 3-for-1 stock split in 1955, and the price range on such exchange during the year of grant, similarly adjusted:

Year granted	Number of employees	Option price per share	Closing market price on date of grant	Price range during year	
				High	Low
1952	91	$16.92	$17.792	$19.00	$15.375
1953	24	16.92	17.333	19.875	16.25
1955	4	28.67	30.125		26.125
1956	96	33.50	34.875	37.75	26.125
1959	56	35.75	37.25	49.75	35.625
1960	12	39.25	41.25	53.50	39.00
1961	34	57.25	60.25	64.50	50.00

The foregoing data become more meaningful when it is realized that no grantee has been allotted more than 22/100ths of 1 percent of the stock outstanding—and that incidentally is in the case of the largest option that was granted—and that options have been granted to a total of 317 key employees. The total stock granted under the option plan since 1952 is less than 8½ percent of the outstanding stock.

It is actually about 5 percent—the amount of stock that has been taken up by the grants and acquired—about 5 percent of the outstanding stock.

If this can be considered a "dilution" of the shareholders' equities, certainly it has been more than offset by the fact that the business has flourished, which has benefited all stockholders, the employees, our customers, the communities in which we operate, and the Government in the form of increased taxes.

The restricted stock option has not only made it possible for our key employees to acquire an ownership in the business—it has stimulated their creativeness and productivity and enhanced their devotion and loyalty. Moreover, in the 9 years that our stock option plan has been in effect, key employees who have purchased stock under the plan have generally retained their stockholdings. This is borne out by the fact that 224,322 shares have been purchased under stock options and the employees who purchased them or their families today own 200,069 shares. There has been no tendency to take a quick profit in the market.

Critics of the restricted stock option would have it appear that this is a device that has been used mainly by larger corporations and for the enrichment of a few favored employees. Even if it were true that only the larger corporations utilize stock options, we believe it is still definitely in the interest of our national economy. But we believe it is widely used among the smaller corporations. I personally know of several small companies whose stock is not traded on national exchanges, yet the stock option is being used successfully to attract high-

grade talent, and these enterprises are making real progress. Many of these small corporations are performing vital service to our defense effort.

In sum, we are satisfied that the plan has provided added incentive for our management group and that as a result it is working in the best interests of all shareholders of our company and, of course, to all other affected groups. We believe this is typical, and the cumulative effect must greatly strengthen our national economy. It would be unfortunate if this plan, which has become ingrained among corporations as an incentive for management, were to be swept away because of a relatively few situations. Let's not burn down the house because the porch needs screening. American industry must perform as never before in these critical days. Abuses can be corrected and defects remedied. Obviously, the subject is worthy of careful study by the Congress before any sweeping change is made.

I thank you for your attention.

Senator GORE. Thank you, Mr. Smith, for your very excellent testimony. You represent a concern that has utilized this provision of the law to a considerable extent, and it is helpful for the committee to have this information which you have so kindly given.

Mr. SMITH. We though it was particularly interesting to note the fact that there has been very little disposal of this stock, and actually only in hardship cases.

Senator GORE. Yes. This is very helpful, and the committee thanks you, sir.

Before you retire—this committee is very happy to welcome you back to its deliberations. You served the committee long, faithfully, and ably.

Mr. SMITH. Many years ago. Thank you, Senator.

Senator GORE. Mr. William Jackman, Investors League.

STATEMENT OF WILLIAM JACKMAN, PRESIDENT, INVESTORS LEAGUE, INC., NEW YORK, N.Y.

Mr. JACKMAN. I am William Jackman, president of the Investors League. Since you are making a plane, Senator, and so am I, I think, if I may, I will file my statement. I do not know if you have read this book, but I am going to give it to you, because the majority of my statement is right in there.

Senator GORE. Thank you, sir.

(The statement of Mr. Jackman follows:)

STATEMENT OF INVESTORS LEAGUE, INC., NEW YORK, N.Y., BY WILLIAM JACKMAN, PRESIDENT

My name is William Jackman. I am president of Investors League, Inc., New York. The Investors League is a nonprofit, nonpartisan, voluntary membership organization of thousands of individual investors, small, and large, residing in every State of the Union.

Mr. Chairman and members of the committee, on behalf of our thousands of investor members I wish to thank you for the privilege of presenting the viewpoint of American investors on S. 1625, a bill by Senator Albert Gore of Tennessee "to amend the Internal Revenue Code of 1954 so as to terminate the special tax treatment now accorded certain employee stock options."

We strongly urge the committee not to recommend this proposed legislation. Senator Gore has stated that the restricted stock option constitutes an in-

equality, "a favoritism in our tax law" which should be repealed. This view seems to suggest that inequality is always bad.

In my opinion, a great many Americans agree with Prof. Henry C. Wallich of Yale University, who points out in his book, "The Cost of Freedom," published in 1960 by Harper & Bros., that "the state of a free society depends on the preservation of beliefs that give room to creative inequalities."

Business is being asked today—by Government, employees, stockholders, and the people—to achieve the economic miracle of steady employment, increasing wages, better and cheaper products, improved earnings and curtailed inflation. This miracle cannot be achieved unless we can get more productivity and growth from the private enterprise system which is the foundation of our society.

The two mainsprings of this private enterprise system are incentives and competition. Because men are not equal in terms of ability, Professor Wallich points out that "one important explanation of, and reason for, inequality follows from the need to get the right people into the right jobs. It is wasteful if engineers do work that mechanics can handle, or if executives perform chores that could be done by their secretaries. A market economy avoids this by compelling business to compete for talent and to pay each man what he is worth in the job he can do best."

Inevitably, however, incentives and competition result in large differentials in income. When we tax away these differentials in large measure, as we are doing today, Professor Wallich points out, "the effectiveness of the selection process * * * suffers correspondingly. A high salary that one cannot keep is no great attraction. Unless we pay people what they are worth, they may see to it that they are worth no more than they are paid. Therefore, if the selection process results in large bonuses, efficiency demands that, in good part, they be left where they land.

"Another instance of creative inequality presents itself when we turn to incentives. Here again, the logic of our system produces inequalities that cannot be removed without slowing down the system itself. If we want good performance, we must hold out rewards. To be effective, rewards must raise one man above the other."

The effort to equalize incomes, if successful, would bring stagnation to our economy, a condition that would be nothing short of a national disaster in the struggle between the free world and the Iron Curtain countries.

Professor Wallich's conclusion, with which I heartily agree, is that "In a dynamic economy inequality acquires a function—it accelerates growth. By facilitating the use of incentives and the accumulation of savings, and so stimulating economic growth, inequality benefits even those who initially appear to be its victims."

My personal knowledge of the results to companies who have adopted stock option plans has led me to the following conclusions:

(1) Stock options are effective in attracting and holding key executives.

(2) Stock options do provide a unique entrepreneurial incentive. They have no value to the recipient, and no cost to the company, at the time they are granted. They become valuable only when management is able to improve the position of the company sufficiently to produce a significant increase in the price of its stock. When this happens, all shareholders benefit. Thus, because of the way stock options function, the individual shareholder is assured of a share value appreciation many times greater than the small fraction of equity which is generally the cost to stockholders of using stock options as incentives.

(3) Stock options do not result in any significant gain or loss in public tax revenues. For example, let us assume that a company pays a $100 cash bonus to an employee instead of issuing a stock option. If the employee is in the 75-percent tax bracket, he pays an income tax of $75 but the company receives the tax benefit of $52. Thus, the Government nets $23 on the transaction. On the other hand, a stock option gain of $100 realized by the same individual would result in his paying a capital gains tax of $25 with no tax benefit to the company.

(4) Until our society can find a better incentive within or outside the tax system the restricted stock option, properly used through built-in safeguards, should be retained to promote the economic welfare of our country.

I submit, gentlemen, that the true interest of America's 15 million shareholders and its free enterprise system will best be served by the Congress rejecting S. 1625.

INVESTORS LEAGUE, INC., NEWS RELEASE

WASHINGTON, D.C.—The head of an organization representing thousands of American shareholders testified today that corporate stock option plans help provide the incentives necessary for continued growth of the U.S. economy.

William Jackman, president of the Investors League, Inc., of New York, strongly urged the Senate Committee on Finance to reject proposed legislation (S. 1625, the Gore bill) which would, in effect, terminate employee stock options.

He said we cannot achieve more productivity and growth from our economy without incentives and competition, "the two mainsprings of our private enterprise system."

Mr. Jackman indicated that any attempt to "equalize incomes," such as that contained in the Gore bill, "would bring stagnation to our economy—a condition that would be nothing short of national disaster in the struggle between the free world and the Iron Curtain countries."

He said, further, that his personal knowledge of the results achieved by company stock option plans has led to the following conclusions:

"Stock options are effective in attracting and holding key executives.

"Stock options do provide a unique entrepreneurial incentive.

"Stock options do not result in any significant gain or loss in public tax revenues.

"Stock options are in the true interest of America's 15 million shareholders and should be retained to promote the economic welfare of our country."

The Investors League is a nonprofit, nonpartisan, voluntary membership organization of thousands of individual investors, small and large, residing throughout the United States.

(By direction of the chairman, the following is made a part of the record:)

NATIONAL SMALL BUSINESS MEN'S ASSOCIATION,
Washington, D.C., July 25, 1961.

Re S. 1625, elimination of stock options.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: I have been operating small business concerns virtually all of my life. I was a charter member of the National Small Business Men's Association, and have just retired as chairman of the board of trustees of that organization.

In my opinion it would be almost disastrous for the small business community to summarily eliminate restricted stock options in the face of the unmistakable fact that this device has constructively served the needs of small business in several important respects. In the first place, on the basis of my own personal experience, the restricted stock option represents the only means available to the small business operator through which he can attract the type of management necessary to compete with the larger concerns. Needless to say the small business concern is virtually never in a position to offer employee security comparable to that of the large firms. Although the element of risk is involved, there is an opportunity to acquire a proprietary interest, and to participate in the rewards which accrue to successful management.

This, to me, is the very essence of the history of American business, and unless we keep this channel open there is no mistake about it we are placing a heavy handicap on thriving young industry.

I respectfully urge that this bill be defeated.

Sincerely yours,

L. M. EVANS,
Chairman of the Board, Telectron Co., Fort Lauderdale, Fla.

NATIONAL SMALL BUSINESS MEN'S ASSOCIATION,
Washington, D.C., July 21, 1961.

Re S. 1625.

Hon. HARRY F. BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: We were prevented, by shortness of notice, from presenting as many small business witnesses as the Senate Finance Committee might desire to hear, who would emphatically and authoritatively testify that the restrictive stock option is an almost indispensable tool in obtaining and holding the type of management which a growing small business must have.

To abruptly terminate all such programs, as proposed by S. 1625, in the face of all the constructive use that has been made of this mechanism, would show a disheartening lack of understanding of the real issues involved. Much of the discussion has gotten off into an emotional sidetrack which has no relevance to the successful operation of the competitive system, or to the welfare of the economy. To characterize, restricted stock options as a moral problem is mere superficiality. Every phase of human activity can involve moral considerations, but the area of restricted stock options is probably less involved in this respect than other phases of business activity. In any event this aspect is merely a supervisory problem, and does not reach to the deeper considerations which ought to dominate the discussion.

One of the principal factors concerned is the effect of these option programs in terms of basic human incentives. Human nature, it must be remembered, has changed very little in 5,000 years. The paramount human motivation was, is, and will continue to be improvement of status on the basis of material possession.

Our tax and other related laws apparently have been thrown together with complete disregard for effect in terms of human reaction and the cumulative impact on the whole economy. Our national policies have provided premiums for waste, sharpness, and inefficiency, and have thrown impediments in the path of commensurate reward for thrift, industry, and competence. This is ignorance of the first order, and we will be paying the penalty for years to come.

Instead of crying about windfall wealth, we should be vitally concerned with seeing to it that every possible door is kept open for opportunity to feed incentive and reward accomplishment. Even the Soviets are beginning to learn, the hard way, that accomplishment is inseparably related to the human drive for monetary reward.

There is currently, in this country, a great due and cry for economic growth. At the same time the national policy seems to be intent on making it impossible to accumulate and keep any appreciable amount of money. What is economic growth if not the product of capital being put to work? Eliminating the option program seems a senseless step in the wrong direction.

In these days of progressive tax rates, the growing small business would find it virtually impossible to get and keep competent management without the help of the restricted stock option. The constructive usefulness of option programs to small business and intermediate companies is perhaps the most important element of the value of such programs as a national resource.

The specific criticisms of such options have been ably and competently answered elsewhere in this record. On the most objective basis, it is clear that every single criticism which has been raised is, at best, a matter of improved administration rather than a weakness in the basic policy.

We respectfully submit that elimination of restricted stock options would be a serious blow to the small business community and to the national economy.

Sincerely yours,

JOHN A. GOSNELL, *General Counsel.*

JACKSON LAKE LODGE, *July 20, 1961.*

Senator BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.:

Register our protest to Gore amendment. Would eliminate incentive for employees to acquire interest in corporations which is a great value in successful operation and would end stock option plans.

SALT LAKE CITY CHAMBER OF COMMERCE,
GUS P. BACKMAN, *Secretary.*

P. R. MALLORY & CO., INC.,
Indianapolis, Ind., May 19, 1961.

HON. HARRY F. BYRD,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: On April 26, the board of directors of this company held an organization meeting following the annual meeting of stockholders. As is usual, officers were elected, their compensation established, and, in the case of two outstanding individuals, stock options were granted. A limited number of stock options have, in past years, been accorded to employees and officers of this company, there being outstanding options in the names of 20 employees (22 including the ones granted April 26).

It was discouraging to me to have to recommend options in the face of the possibility that the bill introduced by Senator Albert Gore of Tennessee would deprive optionees of the tax advantages accorded to holders of restricted stock options as enacted in the Revenue Act of 1964. The reasoning supporting the wisdom behind this legislation is fully set forth in the Senate Finance Committee report and the House Ways and Means Committee Report No. 1337.

There have been, admittedly, a limited number of transgressions against the purpose of the Congress in enacting the legislation. Viewed in comparison to the large number of grants which are in keeping with legislative intent, these few exceptions are of no consequence and should not influence the present Congress to the extent of revoking the benefits which have proved themselves to be of great assistance to American industry.

It may be hard for Senator Gore to understand the significance to an employee of ownership in the company for which he works and the importance to the management that a participation in the ownership of the company's employees signifies. It is not the tax benefit contained in section 421, per se, which is controlling (often these benefits do not materialize as hoped for) but rather the recognition by Congress of the validity and wisdom of the grants to important contributors to the success of a company of an opportunity to own a participation in his employer. If the tax benefits, as contained in section 421, are removed, then the implied approval of this device for spreading ownership of shares of companies which contribute to the growth of the American economy will be eliminated. This would be a serious blow to this company, to American industry and, I suggest, to the welfare of this country. The increase in revenue would be of no consequence in comparison to this blow.

I urge you to oppose legislation of a kind proposed by Senator Gore.

Sincerely,

G. B. MALLORY.

NORTHWEST BANCORPORATION,
Minneapolis, Minn., July 18, 1961.

HON. HARRY FLOOD BYRD,
Chairman, Senate Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR: It has just been called to our attention that a hearing will be held before the Senate Finance Committee on July 20, 1961, on a bill (S. 1625) introduced by Senator Gore of Tennessee to deny the status of qualified stock options issued after April 14, 1961. We do not know how you stand on this matter, but we would like you to know that we are opposed to any bill which would prevent the carrying forward the provisions of plans already adopted under which additional options might be issued.

We believe there are important benefits, other than tax considerations, to be derived by a corporation and its stockholders from an employees' stock option

plan. Our own plan was made effective with approval of stockholders on March 28, 1961. All of our employees 25 years of age and with 2 years of service were qualified for options, with the result that nearly 50 percent of all employees in our group, including tellers, clerks, stenographers, as well as officers, are included. By thus encouraging these employees to become stockholders, we anticipate the plan will stimulate greater personal interest on the part of all employees in our company's future success and that it will provide them with additional incentive to perform their daily tasks more effectively. There are already indications that the plan will materially assist in the recruitment, development, and retention of able and loyal staffs in the Bancorporation, and in its affiliated banks and companies.

The important thing is that ours is not an option plan to compensate a few top officers on a favorable tax basis. Instead, it is a very modest plan devised to encourage a broad base of employee ownership. The fact is that the highest paid officer in the group is entitled to buy only 789 shares with a current market value of less than $35,000.

The worthwhile objectives of our plan, and other plans similar to it, should not be overlooked in the consideration of this bill by the committee. We would appreciate, therefore, having our view, as briefly expressed in this letter, brought to the attention of the committee.

Yours very truly,

R. L. FEDERMAN,
Vice President and Secretary.

WHYTE, HIRSCHBOECK, MINAHAN, HARDING & HARLAND,
Milwaukee, Wis., July 19, 1961.

Re S. 1625.

Hon. HARRY F. BYRD,
Chairman, Senate Committee on Finance,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: I understand a bill has just been introduced to repeal the provisions of the Internal Revenue Code with respect to employees' restricted stock options.

I trust that you and other thoughtful Senators will urgently oppose this repeal. This method of encouraging key personnel in obtaining an interest in the companies they are employed by is very constructive. Far too many corporations are now managed by people who are strangers to an equity interest. I think this is neither wholesome nor good for the country. The greatness of the United States is largely attributable to the entrepreneur who risked his capital in its growth and development. Hence, key management should be encouraged to acquire substantial interests in the companies they manage. If abuses have resulted these should be corrected without destroying this salutary objective.

I urgently recommend that you oppose this proposed repeal.

Very truly yours,

ROGER C. MINAHAN.

MILWAUKEE, WIS., *July 25, 1961.*

SENATE FINANCE COMMITTEE,
Senate Office Building, Washington, D.C.

GENTLEMEN: The writer, as well as hundreds of thousands of so-called small stockholders of corporations, support Senator Gore's bill to end tax benefits on stock options. The number mentioned is predicated on the stockholders' vote in opposition to stock option plans when submitted to a vote of the stockholders.

Aside from the discrimination toward all others engaged in professions, this unwarranted tax benefit preference to a selective group affects the financial interest of the stockholders. The effect of option plans increases the number of shares issued, thereby affecting the market value of the stock and the amount of dividends to be distributed, if any. It cannot be argued that the executives would be similarly affected, because they have procured considerable stock at a lower cost through stock option plans or incentive pay.

The arguments advanced at the hearing in opposition to the bill by John C. Davidson, NAM vice president, are that "this treatment is a logical and reasonable application of tax to the financial results of a transaction which is very much in the public interest," as quoted in the newspapers. The words "logical"

and "reasonable" are misused and misapplied. There is no logic or reason in legalized tax evasion or unwarranted tax benefits to a selective group. His conclusion that legalized tax evasion to a selective group is in the public interest, no greater adverse opinion could be expressed. Tax benefits to a selective group through stock options is to the public's detriment by reason of the loss in taxes.

Prof. Roger Murray, of Columbia University, expressed his opinion according to newspaper accounts. "Stock options are needed because salaries alone are not enough to attract executives from the security of established companies to new firms which need talent." It is apparent his statement is not based upon corporate records, or he entertains an inflated appraisal of the value of executive services and approves by this method to lure and procure executives from other established firms, which in itself is unethical. His statement is untrue in this respect. The stock option plans are not limited to newly employed executives, but cover present executives, and his statement does not include all the fringe benefits that corporate officers and executives receive plus substantial pensions.

It is apparent from the statements of those who testified before the committee that officers of corporations are receiving substantial benefits as a result of stock option plans.

The stock option plans generally are divided into three categories: One for officers, office and factory employees, one for office and factory employees with the greater percentage allowed to officers and executives, and the other for executives only. The conditions of the options vary as to the time of exercising said options and the purchase price. Each of these plans, except skilled mechanics, are initiated under the disguise of an offering to procure top level executives. In reality this group receives top salaries plus numerous fringe benefits at the expense of the stockholders. This becomes more evident when we examine the salaries paid by the corporations. The stockholders who purchase their stock at market prices take all the risk, both in reduction of the prices of their stock and reduction or loss of dividends. In the past year dividends in the majority of the corporations have been reduced generally one-half in the amount formerly declared, and in numerous cases the dividends have been suspended, all to the detriment of the stockholders. The vote in almost all of the cases is controlled by the officers and executives.

On the question of shortage of executive manpower in the United States, President John G. Brooks of Siegler Corp. has this to say:

The widely held notion that there is a shortage of executive manpower in the United States is largely poppycock, no matter what the executive recruiters say, believes President John G. Brooks of Siegler Corp.

"American business is often way overstaffed at the top executive level," said Siegler, who runs his $100 million a year diversified enterprises with a top echelon of four men, including himself.

In fairness and justice to the stockholders, the stock option plan should either be extended to include stockholders who take all the risk, or the plan should be abolished.

On behalf of the many thousands who cannot attend this hearing in favor of the bill, we request the committee for the reasons above stated to support the bill.

Very truly yours,

JOSEPH A. BARLY.

STATEMENT OF WILLIAM L. MCKNIGHT RELATING TO THE METHOD OF TAXING EMPLOYEE STOCK OPTIONS UNDER THE U.S. INTERNAL REVENUE CODE

My name is William L. McKnight. I reside in St. Paul, Minn., and I am chairman of the board of directors of Minnesota Mining & Manufacturing Co. to which, for convenience, I shall sometimes refer as "3M." Minnesota Mining & Manufacturing Co. is a Delaware corporation with principal offices at 900 Bush Avenue, St. Paul, Minn. It was organized in 1902, and at the present time it manufactures and sells a variety of goods in the United States and, by means of its foreign subsidiaries and distributors throughout the free world, including the countries of Argentina, Australia, Austria, Brazil, Canada, Colombia, Denmark, England, France, Germany, Hong Kong, Italy, Japan, Mexico, Netherlands, Norway, Puerto Rico, Switzerland, and South Africa. In accomplishing this, 3M and its subsidiaries employ approximately 28,000 people. Minnesota Mining & Manufacturing Co.'s common stock without par value is now, and has been since January 6, 1946, listed and sold on the New York Stock Exchange.

Prior to 1949 I, and other executives at 3M, received numerous requests from 3M personnel for a plan whereby the employees of 3M and its domestic subsidiaries could acquire common stock in 3M. Their wishes, coupled with the multitude of benefits which broadened employee ownership of 3M could mean for this company, led to an attempt by our management to make such a plan available to all its employees on a nondiscriminatory and workable basis.

As a result, in August of 1949 the board of directors of 3M adopted an employees' stock purchase plan in which all permanent employees, except the directors, were eligible to participate. The plan, together with proxy material meeting the requirements of the Securities and Exchange Commission, was submitted to the stockholders for approval and was ratified on September 16, 1949, by a vote of 1,564,163 shares in favor of the plan and 6,868 shares against the plan. Of the favorable majority, 821,635 shares, or 41.6 percent, of the 1,972,845 issued and outstanding shares entitled to vote, were owned by directors or their associates, and all of these shares were voted in favor of the plan despite the fact that directors could not participate in the plan and the further fact that they knew their equity in the company would be diluted. After its ratification, the stock purchase plan was offered to all permanent employees of 3M and its subsidiaries, on the basis that employees could purchase an amount of common stock of 3M equal in value to 10 percent of their compensation. Under this plan, 75,000 shares had been made available for sale, and after the 1951 4-for-1 stock split employees could have purchased 300,000 shares.

By its terms, on December 5, 1952, the plan expired. Under it the company sold 134,476 shares of its common stock to 2,792 of its domestic employees. At that time 3M had 10,615 domestic employees so that 26.3 percent of them had a proprietary interest in the company.

The success of our plan and of similar plans in other companies, as well as the enlightened tax legislation regarding such programs which was enacted by Congress in 1950, increased our enthusiasm for this method of encouraging broader company ownership by employees with all of such owenrship's good effects for 3M and its stockholders.

Hence, on February 13, 1954, the board of directors of 3M adopted two restricted stock option plans to be submitted to the stockholders at the company's annual meeting on May 11, 1954. Under these proposed and ultimately enacted plans, all permanent employees of 3M and its domestic and Canadian subsidiaries were eligible to participate except Mr. A. G. Bush, chairman of the executive committee, and myself. On May 11, 1954, 81.4 percent of the issued shares of 3M common stock were voted in favor of the executive restricted stock option plan and 81.2 percent voted in favor of the general restricted stock option plan. Only 0.3 percent opposed the executive plan and 0.4 percent opposed the general plan. At this time 2,812,303 shares of 3M common stock (34.2 percent) were held by Messrs. Bush, Dwan, Ordway, and myself, all of whom were members of the board of directors and all of whom, though not eligible to participate in the plans and aware that adoption of the plans would dilute our holdings, nevertheless voted for both plans.

Under the terms of these plans, a maximum of 150,000 shares of 3M common stock without par value was to be available for options to be granted to the executive employees of 3M and its subsidiaries in the executive restricted stock option plan; while a maximum of 200,000 shares of 3M common stock without par value was made available for the options offered to permanent 3M employees other than executive employees under the general restricted stock option plan. The executive plan limited the maximum number of shares which any participant might purchase under it to an aggregate of 7,500 shares. Six thousands employees of 3M and its domestic subsidiaries purchased 595,002 shares under the 1954 general plan; and as of June 30 of this year, 746,284 shares had been purchased by 69 domestic employees under the 1954 executive plan. These latter figures reflect the two stock splits to date.

After the expiration of the general restricted stock option plan which had been adopted in 1954 and because of its universal employee acceptance, the board of directors of 3M on February 10, 1958, adopted two further restricted stock option plans known as the 1958 executive restricted stock option plan and the 1958 general restricted stock option plan, which were submitted to the stockholders of 3M at the annual meeting on May 13, 1958. Under the terms of these plans, all permanent employees of 3M and its domestic and Canadian subsidiaries were eligible to participate except Messrs. Bush, Halpin, Dwan, Ordway, Connolly, and myself, all of whom were directors of 3M. On May 13, 1958, the stockholders ratified the 1958 executive restricted stock option plan when 89.9

percent voted for the plan and 0.5 percent voted against it, and they ratified the 1958 general restricted stock option plan when 89.9 percent voted for the plan and 0.6 percent voted against it. At the time of this vote, 5,839,527 shares (34.7 percent) were owned by Messrs. Bush, Dwan, Ordway, Halpin, Connolly, and myself, members of the board of directors who were not eligible to participate in either plan but voted for them.

Under the executive plan, a committee of the directors determines the number of shares to be optioned from time to time to each participant, limited by the plan so that the maximum number of shares which any participant may purchase cannot exceed in the aggregate 8,000 shares. As of June 30, 1961, 12,326 domestic employees had purchased 368,106 shares of stock under the 1958 general plan and 369 domestic employees had purchased 162,713 shares of stock under the 1958 executive plan. These figures are adjusted for the two stock splits to date.

I have taken the liberty of giving you this extensive review of the stock option plans which 3M has offered its employees so that you might have a better perspective for the comments I wish to make in defense of the present tax treatment these plans receive. I feel that the restricted stock option plans as contemplated by the Internal Revenue Code of 1954 are valuable incentives and that the present taxation of such plans is sound and in the interest of the corporation, the employee, and the public.

I say that the present method of allowing the recipient of a qualified restricted stock option capital gains rate on any increments in the value of his shareholding, is sound corporate thinking because any cost to the corporation is money well spent in view of the better employees it makes. The stock option is the finest of incentives in that its effectiveness continues throughout the optionees' employment with the company. It enables the employee to comprehend something more than short-range economic benefits and to identify the corporation's well-being with his own. The encouragement given to employee stock ownership by the present tax law is necessary to effectuate this corporate policy, and certainly in our company its value can be seen. In 1952, at the end of our first plan, and the earliest source of pertinent data available to me, 3M had 10,615 domestic employees of whom 2,700 were shareholders. In March 1961, we had 21,069 domestic employees of whom 10,881 or 51.64 percent were stockholders. In other words, we had doubled our working force and more than quadrupled our number of employee shareholders.

The benefit of the present tax law to the employee is correlative to the benefit received by the corporation. If anything, the interests of shareholding employees are appealing to management. The very real concern which good employees have with the progress of their employer is given added impetus as well as authority when the employee is a partial owner of the otherwise abstract creature for whom he toils. The employer is compelled to see the very real stake which such employee has in the success of the common enterprise. In the long-range view, the tax benefit enables the employee to provide something by means of his own industry and thrift which can make him financially secure. The partial ownership which, because of the incentive, the employee sees fit to sacrifice for is really a partial ownership in free enterprise—an interest in American capitalism. Certainly, at 3M where in 1952 there were 10,615 shareholders of whom 2,700 were employees and in 1961, 74,981 shareholders, of whom 10,881 were employees, the effectiveness of the present law cannot be gainsaid. While the number of our shareholders has multiplied by 6 in the last 8 years, the proportion of employee-owners or shareholders has remained the same, namely, one in seven shareholders works for the company. This figure, I think, is even more impressive when it is realized that 3M is far from being a small closely held corporation but is rather a publicly held and actively traded company.

I mentioned earlier that I was convinced that the present method of taxing stock option plans was good for the public in whose interest the tax law exists. When, in 1950, the Congress enacted the enlightened legislation presently governing this subject, all of us who were attempting to do something to broaden the ownership of American business, were gratified. I am confident that you and all thinking men realize that broadened stock ownership by the employees of this Nation cannot but help to promote and protect the free enterprise system upon which our way of life depends.

3M has long been convinced that its employees have a greater stake in the company than the salaries and wages so readily thought of. This is especially true of the permanent employee upon whose efforts the corporation, in large

measure, either succeeds or fails. You, yourselves, know that it was this type of thinking, namely the total obligation of the employer to the employee, which led to the creation of unemployment insurance, workmen's compensation, and pension and profit-sharing plans of various kinds. All of these enlightened industrial programs are used by 3M, but I am convinced that the opportunity of becoming a partial owner of the business, which our employees can, is a benefit of inestimable value, and I am further convinced that the encouragement of such ownership is only practicable by means of an enlightened and wise tax policy. Any man who works hard for his wages must indeed see a benefit if he is to deny himself a portion of his earnings and assume the position of an investor in America's business. For the employee investing his money, like all investors, is subject to risk of loss as well as chance of gain. To say that one favors broadened corporate ownership without making such ownership attractive to the employees of America is but to desire a noble end while failing to provide the means which will make it possible.

In the long run, I cannot but think that the modest tax benefits which accrue to optionees under the qualified stock option plan are of greater productivity to this country than the same money would be had it gone into the coffers of the Government. The immediate benefit of this tax treatment is the broadened stock ownership which it encourages in the employee as well as the recognition which it forces upon the business that the growth and ultimate success of any enterprise must in some measure be passed along to the employees whose efforts, in large part, made possible such success as the enterprise enjoys. If there are abuses, and for some reason they seem always to occupy the forefront of attention, I, with you, deplore them. There are laws presently on the books to prevent the use of stock option plans as a mere tax evasion device. If these laws are inadequate, they should be speedily remedied, but it is incomprehensible to me that in order to remedy these rare abuses, it is necessary to repeal existing law relating to employee stock option plans and, thereby, destroy this effective means of broadening opportunities for employee ownership by removing the incentive which presently exists. If such a reactionary policy is undertaken and if the stock option is to be debilitated as an incentive, then I fear that the "house is being burned down merely to catch a mouse." Surely, it is within the power of the Congress of the United States to prohibit any misuse of this marvelous incentive, the effectiveness of which I am ready to bear witness to.

WRIGHT-PORTER, INC.,
New York, N.Y., July 26, 1961.

Mr. HARRY F. BYRD,
Chairman, Senate Committee on Finance, Care of Mrs. Elizabeth B. Springer, Clerk, New Senate Office Building, Washington, D.C.

MY DEAR MRS. SPRINGER: I greatly appreciate your kindness to me last Thursday when I called at your office to see if I could serve as a witness before the committee reviewing the merits and demerits of the restricted stock option. May I submit for the review of the committee the draft material attached which presents my thinking on the effectiveness of the restricted stock option. This testimony was presented to the Securities and Exchange Commission (file No. 70-3777) by legal representatives of the Middle South Utilities, Inc.

I would welcome the opportunity to present my views in person should they be desired by the committee.

Very sincerely yours,

EDMOND F. WRIGHT.

EDMOND F. WRIGHT—QUESTIONS FOR DIRECT TESTIMONY

1. Question. Mr. Wright, will you please state your full name and address for the record?

Answer. Edmond F. Wright, 122 Brattle Street, Cambridge, Mass.

2. Question. Are you with any firm and, if so, will you please state its name and address and your position with such firm?

Answer. I am chairman of the board and a stockholder of Wright-Porter, Inc., 280 Park Avenue, New York, N.Y.

3. Question. What is the business or profession in which you and your firm are engaged?

Answer. We are counselors and advisers to senior management of numerous corporations on organization planning, executive recruiting, and building executive growth programs.

4. Question. Please state your educational background, including the degrees you hold, any academic positions you have held or honors which have been conferred upon you.

Answer. I hold a bachelor of science degree from Harvard College, awarded in 1924.

I received the degree of master of business administration from the Graduate School of Business Administration, Harvard University, in 1926. My studies were concentrated in two fields: namely, personnel relations and accounting.

After graduation, I served a period of 10 years on the staff of the Harvard Business School. My service was in the capacity of assistant dean, lecturer on executive personnel relations, and instructor in the course on finance. During this period I organized the Harvard Business School Placement Bureau, ultimately receiving the title of director of placement and director of alumni relations.

In 1936 I left the Harvard Business School and shortly thereafter accepted a position with McKinsey & Co., consultants to management, to set up for that firm an executive selection department. The function of that department was to recruit executives for the various clients being served by McKinsey & Co.

I returned to the Harvard Business School in 1942 at the time of the return to the business school of Donald K. David, as dean of the school. Dean David assigned to me the title of assistant dean, and during many periods of his absence I also served as associate dean.

During this period at the business school I also was assigned the administrative deanship of the advanced management program, which has developed into one of the chief adjuncts of the business school. This is an educational program developed by the business school faculty under which program executives of the leading corporations of the country attend a 16-week program styled a "refresher" course. Over 3,500 outstanding corporate executives have attended this course to date.

During the period of my latter service on the business school staff, I was also editor of the Harvard Business School Alumni Bulletin and carried out further responsibilities in both placement and alumni relations. During my service on the staff of the business school, I wrote articles on executive placement.

I was with the Harvard Business School until 1948.

5. Question. In addition to your business experience, have you had any experience in Government positions and, if so, would you state what they are?

Answer. Yes. I served with the U.S. Federal Government as well as with the United Nations.

Shortly after the beginning of World War II, I was asked to come to Washington to serve as executive personnel officer of the War Production Board, reporting to Donald M. Nelson, the Chairman of that Board. I also worked with Charles E. Wilson, Vice Chairman of the War Production Board, and Sidney M. Weinberg, another Vice Chairman of that Board. This assignment called for the selection of businessmen in various fields of endeavor to serve in setting up the production program of a given industry or phase of industry. The recruiting which I did in connection with my service to the War Production Board was of men of the caliber and in the occupation of corporate executives. My service lasted from early 1942 through June of 1943, at which time I returned to the Harvard Business School.

I have also served with the United Nations. I received a leave of absence from the Harvard Business School for this purpose in 1946. At that time I became the acting director of personnel for the United Nations. My service with the United Nations covered the period from April 16, 1946, to January 1, 1948, when I returned to the Harvard Business School.

6. Question. Would you please state your business connections and experience.

Answer. As I have testified, shortly after leaving the Harvard Business School in 1936 I accepted a position with McKinsey & Co., consultants to management, to set up for that firm an executive selection department whose function was to select executives to be assigned to the various clients of that firm.

In 1948, recalling the pleasure I had in setting up this type of department for McKinsey & Co., I accepted a position with Griffinhagen & Associates to set up for this consulting firm in Chicago a similar department, which function I performed from 1948 to 1952.

This was a successful venture and I was then asked to join the staff of Handy Associates, Inc., which firm specialized in executive recruiting, and I served with that firm for four years.

I then established my own firm, Wright-Porter, Inc.

7. Question. Please describe the precise nature of the business conducted by your present firm, Wright-Porter, Inc.

Answer. The purpose of our business is to assist management in building the executive pyramid soundly, striving for what I call "capacity in depth."

We work with management in developing its executive program, often being called upon to evaluate the capacity for management of the firm's existing executive staff, then indicating to management where weaknesses have been found, and cooperating with management in bringing in executives with the capacities to fill those weak spots; in short, to bring strength to all executive levels. There is involved a review and analysis of the jobs to be performed at the executive level for the particular client company; an analysis of whether certain new jobs should be created or old ones abolished; a survey of the capacities and abilities of the executives who presently hold particular jobs; an analysis of the entire compensation program at the executive level, including salaries, bonuses, pensions, and stock options; and the formulation of a recommended program for the board of directors.

8. Question. Does your firm in effect act as an employment agency for executives who are seeking positions?

Answer. No. We act exclusively as consultants to corporate management and are responsible to the corporation. We are always paid by our client companies and not by the men whom we place.

9. Question. Am I correct in saying that you, Mr. Wright, are often referred to as the dean of your profession?

Answer. That is correct.

10. Question. How many corporations have been your clients for services of the kind you have described?

Answer. Professionally, in my associations with Wright-Porter, Inc., and the two previous consulting firms of which I was an officer, I and those under my direction have served over 400 leading corporations.

11. Question. Do you mind naming some of the clients for whom you have performed these services?

Answer. Among recent ones or presently on my list are, for example, Bethlehem Steel Corp., Fansteel Metallurgical Corp., Scott Paper Co., Marquette Cement Manufacturing Corp., American Electric Power Co. (formerly American Gas & Electric Co.), Commonwealth Shoe & Leather Co., Pullman, Inc., United Shoe Corp., American Machine & Foundry Corp., Babcock & Wilcox Corp., Merck Chemical Co., and many others.

12. Question. Can you give us some indication of the number of key personnel you have placed with various corporations in the past 15 years?

Answer. Several thousand, including the figure for replacement of Harvard Business School alumni returning from World War II. In the last 10 years, in my association with Wright-Porter, Inc., and the two previous consulting firms of which I was an officer, I and persons under my direction have placed approximately 650 key personnel.

13. Question. What is the range of corporate positions covered by those placements?

Answer. The entire range of corporate positions, including chairman of the board, president, and so on, right down to the lower executive levels.

14. Question. What would be the salary range of key personnel placed by you?

Answer. I have placed men as high as $100,000 per annum and down to $10,000. I would believe that my average range is in the $25,000 to $35,000 level. These figures, of course, do not take into account pension and retirement plans, stock options, and other forms of compensation and incentives.

15. Question. As a part of the conduct of your business, do you discuss with executives who are contemplating changes of positions the factors which impel them to make such changes such as salary, retirement plans, stock options, and the like?

Answer. Definitely so.

The issue of compensation is covered most thoroughly in every instance and questions as to stock options almost always arise.

I have found that the executive of today generally will not move from a position with one corporation to another for a salary increase alone. The additional

amount which he would have left after taxes, even on a substantial increase, is so negligible as to constitute only a slight inducement.

There is an insistence by the executive upon some form of compensation whereby he may provide for his future.

The form of compensation which is being more and more emphasized by today's executives, in this connection, is a stock option. Ordinarily the most feasible method for an executive to acquire some capital is the stock option. Furthermore, the modern executive, in my experience, likes to have a feeling of ownership in the enterprise of which he is a part. Therefore, a stock option plan is one of the best incentives to attract him.

16. Question. Have you found that stock options have constituted an effective inducement in attempting to persuade an executive to accept a new position?

Answer. Yes. In my experience in executive recruiting I have repeatedly found that stock options have constituted a most effective inducement in bringing to an open position a highly desirable executive. In fact, because many an executive is "cemented" into his present position by a retirement or pension plan, it is my experience that he will ordinarily not move unless there is a potential fo reapital gain.

17. Question. Would you please give us some evidence of that fact?

Answer. Certainly. One example is a leading executive currently with one of the large Detroit automotive firms who is considering a change of position. His principal requirement as to a new position is a company with a generous stock option plan. He has told me that he has been unable to accumulate any appreciable capital in spite of his very high past salaries and extremely responsible positions and that this is the reason he desires a change. He has asked me to secure for him at least 10 company proxy statements in order that he could get an "average" of the stock option plans of these companies. The companies requested with such stock option plans are: Montgomery Ward; Sears, Roebuck; McGraw-Edison Electric; Whirlpool; Motorola; Colgate-Palmolive; Procter & Gamble; Crane; Commercial Solvents; and St. Regis Paper. He has informed me that he will not go to a company not having an attractive stock option plan.

Another typical example is that of a very able individual who was executive vice president of a Hartford Conn., machine tool company and I secured him to serve as president of a Cleveland machine tool company. Before this individual would leave Hartford to come to Cleveland, he received from the board of directors a specific commitment as to an attractive stock option. Only upon the signing of this agreement, would this individual accept the post.

Another example is that of an extremely able executive with one of the leading pharmaceutical and cosmetic firms who was not ready to move to a competitor's firm until he was guaranteed 2,000 shares under a stock option plan. Upon agreement, he shifted to the competitor.

I consider the foregoing examples to be typical of my experience.

18. Question. How many men placed by you in the past 10 years received stock options or promises of them as inducements to accept the new positions?

Answer. Based on the period of my association with Wright-Porter, Inc., and the two previous consulting firms already mentioned in my testimony, there were an average of five to seven senior executives placed annually who either received stock options immediately upon reporting for assignment to their new connection or were informed that a stock option program was assured in the future. Many others, of course, discussed the availability of stock option, either immediately, or ultimately, in connection with their placement.

19. Question. Based upon your experience in securing key personnel, what is your opinion as to the importance of stock options as a motivating force in inducing such personnel to accept positions?

Answer. Based on my experience, it is my opinion that the stock option is one of the chief means of attracting an individual from one position to a higher position in another company and that its importance in this respect will increase even further. A salary is subject to heavy taxation; a pension is something that is now being taken for granted. On the other hand, the stock option, the executive feels, can provide capital necessary for the future of himself and his family, the added enjoyment of his retirement and the passing on of even a limited estate to his children.

20. Question. Please describe some specific instances in which corporations have failed to get good men because of the absence of stock option plans.

Answer. One recent example is that of an executive I was attempting to get for a food company. My client failed to attract the most eligible individual because that individual would have had to give up a desirable stock option held by him with his present company and my client was unable to match this stock option.

21. Question. You have now testified as to the importance of stock option plans as instrumentalities for getting key personnel. Has it been your experience that stock options are effective instruments for a corporation to retain key personnel against the competing bids of other employers?

Answer. Yes. I know from experience that extremely able men have refused to leave their existing positions because if they did so they would sacrifice their existing stock options. Stock options anchored them to their positions.

22. Question. Would you please give specific examples of situations in which an executive has refused to take a position with a new employer because of his rights under a stock option plan with his present employer?

Answer. Yes. One example relates to an able executive of the Standard Oil Co. of New Jersey, who had served with that company for 27 years. He was being bid for by a small metal-stamping firm in northern New Jersey, and gave a great deal of consideration to the opportunities available to him in this smaller firm. After lengthy deliberation, he reported that he could not accept an offer from this small manufacturer because he would thereby lose the stock option granted to him by Standard Oil of New Jersey.

23. Question. Would you please give some specific examples of situations in which companies have lost key personnel because they did not provide such personnel with stock options?

24. Question. Have you had experience in the placing of new men who are just starting on a business career, that is, have you assisted in placing them or advising them as to where they should go and discussing their plans with them?

Answer. Yes. I have had such experience with literally thousands of cases. This was my work while on the staff of the Harvard Business School. Even today, I have a great interest, quite aside from my job, in advising young men in starting a business career. I am constantly being requested by the parents of young men or the young men themselves to give advice as to a career. For example, a few weeks ago four individuals came to my home in Cambridge on one Saturday alone to discuss this very problem with me.

25. Question. Can you state whether or not, in your experience, stock options, even though not immediately available, are among the considerations which they take into account?

Answer. While there is not the same emphasis on stock options in the minds of the younger men, the subject generally arises and my advice to them is to get with a firm having a policy of stock options because such stock options will one day, if the men work out, be available to them.

My experience is that the presence or absence of a stock option plan in a given corporation or industry weighs heavily with the young men in deliberating on a position.

26. Mr. Wright is working on any helpful data which he may be able to secure as to public utilities.

27. Question. As a result of your experience, is it your opinion that a company which is precluded from offering a restricted stock option plan is at a disadvantage in securing personnel for its responsible executive positions?

Answer. Definitely so. The stock option, as I have already testified, appeals greatly to the responsible executive. He sees in it the opportunity of a capital gain, depending upon the success of the business in the management of which he is participating, which is possible through no other medium. A company which cannot offer this incentive is, therefore, at a great disadvantage.

28. Question. What, in your opinion, would be the effect of such competitive disadvantage upon the quality of key personnel which would be attracted to the company or industry suffering under such a disadvantage?

Answer. In my opinion, "mediocrity" in the executive pyramid is practically an assured end result of such a policy. It is my experience that good men are increasingly demanding that they receive some recognition for their part in serving management well. Such good men increasingly tend to shun companies without stock option plans. Men of proven ability expect some share in the benefits of success.

29. Question. On the basis of your experience and knowledge, is it your opinion that stock options are appropriate and conducive to the economical and

efficient operation of a publicly held corporation and that such a corporation generally gets full value for the stock options it issues?

Answer. Yes. In the first place, a corporation can give the same amount of after-tax compensation by means of stock options far more cheaply than by means of salary. This necessarily follows under our tax laws. In the second place, I have found that the efficient and economic operation of a corporation depends upon the ability of the corporation to attract and retain individuals of the greatest possible executive capacity. As I have already testified, stock options are a prime basis for attracting and retaining such individuals.

In the third place, the granting of stock options gives the executive a stake in the economical and efficient operation of the corporation by which he is employed. Obviously the more efficient the operation and the lower the cost, the greater will be the net worth of the corporation and of the stock in the corporation to which the executive is entitled through exercise of options. In the fourth place, the corporations which I have advised and aided in executive recruitment have found that they did receive great values through stock option plans. And, as I have testified, I know that the ability of these corporations to attract and retain persons of top executive ability has depended, to a large extent, on the availability of stock options.

30. Question. As a result of your experience and knowledge, is it your opinion that the availability of stock options in a corporation generally promotes the interests of the stockholders of the corporation and the consumers of the corporation's products?

Answer. Yes. On the basis of my experience, I have found that the issuance of stock options gives the option holder a stake in the corporation and in the value of the corporation's stock. As a potential stockholder, he has a direct interest in increasing the value of the stock through, among other things, the efficient and economic operation of the enterprise. This certainly benefits the stockholders. It also should benefit the consumers.

Furthermore, as far as the stockholders are concerned, it costs the corporation—and therefore the stockholders—considerably less to give an executive the same amount of after-tax compensation by means of stock options than by means of a salary.

Finally, the great help which stock options give to a corporation in retaining and hiring able executive personnel, of necessity results in benefits to both stockholders and consumers.

CONTROLLERS INSTITUTE OF AMERICA,
New York, N.Y., July 28, 1961.

HON. HARRY FLOOD BYRD,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR BYRD: We appreciate the opportunity to present to the Senate Finance Committee the views of the Committee on Federal Taxation of Controllers Institute of America with respect to Senate bill S. 1625 on Employees' Stock Options under Internal Revenue Code Section 421.

The Controllers Institute is a financial management organization with a membership of more than 5,000 financial and accounting officers of leading companies. Their responsibilities normally include responsibility for controlling costs and the evaluation of programs, plans, and expenditures to insure that their corporations receive the maximum return therefrom. Our committee opposes the adoption of Senate bill S. 1625.

Stock ownership in the employer corporation is the most direct method of giving employees the incentive to achieve company and stockholder objectives. By providing employees with a means of sharing in the profits of successful operation, the company and its general shareholders can be more assured of continuing devotion to their best interests which will produce profits. The employee is thus put in the same position as a proprietor or a partner with a direct interest in profit or performance.

Stock option plans are designed as a means of securing the benefits of employee stock ownership more readily and advantageously. Stock option plans are usually approved by the shareholders before becoming operative, and such approval is a clear indication of stockholder appreciation of the benefits which can be achieved from such ownership. The Securities and Exchange Commission, in a recent release, stated that "options do in fact, constitute a material factor affecting executive recruitment and retention."

Employee stock ownership is vital to successful corporation operation in today's economy. Particularly with younger managerial talent, high personal tax rates and high costs of living "up to the job" make it almost impossible for anyone not blessed with inherited wealth to accumulate the necessary capital to purchase stock. A stock option plan, properly qualified, admittedly provides an economic interest in the growth of the company.

Internal Revenue Code Section 421 was designed to encourage the development and retention of talented employees, that is, only options issued to employees qualify as restricted stock options, the option must be personal to the employee (he cannot transfer it), the price of the stock purchasable under the restricted stock option cannot be less than 85 percent of the market value of the stock on the date the option was granted, sale of the stock purchased under a restricted stock option must be at least 2 years after the date of the granting of such option, et cetera. Senate Report No. 2375, 81st Congress, 2d session (1950), justified enactment of section 130-A of the 1939 Internal Revenue Code, dealing with "employees' stock options," the predecessor to section 421 of the 1954 Internal Revenue Code, as follows:

"* * * Such options are frequently used as incentive devices by corporations who wish to attract new management, to convert their officers into 'partners' by giving them a stake in the business, to retain the services of executives who might otherwise leave, or to give their employees, generally, a more direct interest in the success of the corporation.

"* * * The rule applied under existing regulations is that an employee exercising an option to purchase stock from his employer corporation receives taxable income at the time the option is exercised to the extent of the difference between the market value of the stock at the time of exercise and the option (or purchase) price. The difference is taxed as ordinary income, rather than as capital gain, on the theory that it represents additional compensation to the employee. Since the employee does not realize cash income at the time the option is exercised, the imposition of a tax at that time often works as a real hardship. An immediate sale of a portion of the stock acquired under the option may be necessary in order to finance the payment of the tax. This, of course, reduces the effectiveness of the option as an incentive device.

"* * * Under your committee's bill, no tax will be imposed at the time of the exercise of a 'restricted stock option' or at the time the option is granted and a gain realized by the sale of the stock acquired through the exercise of the option will be taxed as a long-term capital gain. Such treatment is limited to the 'restricted stock option' for the purpose of excluding cases where the option is not a true incentive device. Options which do not qualify as 'restricted stock options' will be continued to be taxed as under existing law.

"* * * Thus, under the bill, the employee will receive special treatment only if he remains in the employment of the company for a substantial period after the time when he acquires the option and actually invests in the stock of the company for a considerable period.

"* * * Since the options which qualify for special treatment are regarded as incentive devices rather than compensation, no deduction is allowed the corporation under section 162 with respect to a transfer of stock pursuant to a restricted stock option."

National interest is focused directly, today, on the problem of stimulating economic growth in the United States. Recognition is universal of the part which must be played in such growth by the Nation's corporations, large and small. Equal recognition must be given to the fact that such growth will depend in a large measure on the effort and interest of persons employed. This effort and interest has suffered in recent years as ordinary rewards for the time and strain involved have been taxed so heavily as to render them increasingly ineffective. If the Nation is to obtain maximum results from its available manpower in the years ahead, it must seriously consider the retention of incentives—such as stock options—for successful performance. Section 421 of the Code should therefore be retained—not destroyed, as would be the case with the enactment of S. 1625.

Respectfully submitted.

FRANK V. OLDS,
Chairman, Committee on Federal Taxation.

AMERICAN TELEPHONE & TELEGRAPH CO.
New York, N.Y., July 28, 1961.

HON. HARRY FLOOD BYRD,
Chairman, Senate Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: We were unfortunately unable to be represented at the hearings held last week by your committee on the proposal contained in S. 1625 to modify section 421 of the Internal Revenue Code of 1954. It was with some concern, however, that we noted that the testimony which was presented at these hearings was directed almost exclusively to discussion of the so-called incentive type stock options which are offered for the most part only to top management people. We believe there is considerably more at stake in this matter than would appear from the material presented to you at the public hearings.

It appears to us that the termination of the restricted stock option provisions of section 421 would deny the modest advantages presently contained in the law applying to the capital-raising type of stock-purchase plan which is now used by many business organizations as well as to the incentive or compensatory type of option used by some others. This could work a substantial hardship on those corporations using the restricted stock option provisions, not to provide compensation but as an essential part of their equity financing programs. This, I believe, would be a most unfortunate development.

It is generally conceded that additional compensation is an essential element of the incentive option which is offered exclusively to top management employees. As compensation for his efforts, an executive is given something of value, perhaps of great value, in the form of an option to purchase stock, with no prior investment on his part. The person holding such an option may never exercise it and never make any investment in the business unless the stock rises substantially in price. The business reason for granting an option of this kind is to provide a type of deferred compensation for the executive and for this reason such options may serve a very necessary purpose. These options, however, are in no way related to the need for additional capital in the business.

The purpose of the capital raising purchase plan arrangement is quite different. As in the case of this company's employees' stock plans which have been in operation from time to time since 1915, the primary purpose is to raise capital as needed by the business by extending to employees generally an opportunity to purchase stock of the corporation on terms no more favorable than is considered necessary to produce the desired participation. Our employees' stock plans have provided, in the great expansion periods following the two World Wars, over 12 percent of the common stock capital raised by the Bell System and are providing a significant portion of current equity capital requirements. Offerings under such plans are not limited to top management, but, on the contrary, include the employee body generally. In our own case, a total of 395,000 employees of American Telephone & Telegraph Co. and its subsidiaries, not including the officers of this company who are specifically ineligible, are currently participating in our plan. Furthermore, the definite limitation as to the number of shares which may be purchased under such plans is designed to permit participation on a modest scale by employees in all classifications over an extended period of time through installment payments.

Our plans are not intended to provide additional compensation to the employees. The differential between purchase price and market value represents only the reasonable underpricing necessary for the successful marketing of new stock in the necessary amounts. Equally important, our plans afford employees an opportunity to save systematically and are designed to induce employees to invest their savings in the business of which they are so integral a part. I believe that this is important to the economy of the Nation since it gives employees an opportunity to acquire a stake in the American free enterprise system on a fair basis.

Unfortunately this type of arrangement will be in jeopardy should the restricted stock option provisions of section 421 of the Internal Revenue Code be terminated. It is our belief, however, that those who advocate the repeal of these provisions do not wish to see unwarranted limitations or unneeded controls placed on the capital raising type of option. The incentive or compensatory type option has a distinct function in our economy as has the capital raising type. Inasmuch as each has its own unique business purpose, one type of option should not be confused with the other and these inherent differences should not be overlooked.

We strongly urge, therefore, that in considering any modifications of section 421 of the code, no change be made which would eliminate the modest advantages now contained in the law which make possible the widespread use of capital raising stock purchase type arrangements such as those presently in use by this and many other growing businesses in our Nation.

If it is not too late to do so we respectfully request that this letter be included in the record of the hearings by your committee relating to S. 1625.

Sincerely yours,

A. L. STOTT, *Vice President and Comptroller.*

MACHINERY & ALLIED PRODUCTS INSTITUTE,
Washington, D.C., July 28, 1961.

Hon. HARRY F. BYRD,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

PROPOSAL TO REPEAL THE RESTRICTED STOCK OPTION PROVISIONS OF THE INTERNAL REVENUE CODE

DEAR MR. CHAIRMAN: We appreciate the opportunity to present the views of the Machinery & Allied Products Institute with respect to S. 1625 which would repeal the current provisions of tax law concerning restricted stock options.

The institute and its affiliate, the Council for Technological Advancement, represent the capital goods and allied industrial equipment industries of the United States. Skilled, efficient, and experienced corporate executives, dedicated to the welfare of the corporations by which they are employed, are of crucial importance to the capital goods as well as to other industries. Adoption of the proposal currently pending before this committee is likely to deny to industry the use of one of the most effective available incentives to superior executive performance—the restricted stock option.

TAX TREATMENT OF STOCK OPTIONS

Section 421 of the Internal Revenue Code provides that no tax will be imposed on "restricted" stock options—i.e., employee stock options qualifying under certain specific statutory criteria—until the employee sells the stock. When the option price is 95 percent or more of the market value of the stock at the date the option is granted, the ultimate gain (the difference between the purchase price of the stock and the proceeds realized upon its sale) is taxable at capital gains rates. If the option price is less than 95 percent but at least 85 percent of the market value of the stock at the time the option is granted, a somewhat different rule is followed. The gain is not taxed until the employee disposes of the stock, but the lesser of the difference between the option price and the fair market value of the stock on the date of grant, and the option price and the market value on date of sale, is taxed as ordinary income. The balance of the gain, if any, is treated as a long-term capital gain. If an employee stock option does not qualify as a "restricted" stock option, the tax treatment is entirely different. Tax is imposed at the time the option is exercised and the stock is acquired; the gain represented by the excess of the market value of the stock at the date of exercise over the option price is taxed as ordinary income.

THE PROPOSAL TO REPEAL STOCK OPTION PROVISIONS

S. 1625, introduced by Senator Gore, a member of the Committee on Finance, would in effect repeal the special treatment afforded stock options by amending section 421 of the code to provide that employee stock options granted after April 14, 1961, the date the bill was introduced, could not qualify as restricted stock options.

There appears to be a presumption underlying this bill that the present code treatment of restricted stock options constitutes an unwarranted tax gimmick which was added to our tax law without adequate justification. We suggest that the basic reason for enacting the restricted stock option provision—providing specific incentive for corporate executives to acquire a proprietary interest in the corporation for which they work—was sound at the time the Finance Committee recommended adoption of this provision in 1950, and continues to be sound.

As we understand it, the bill's sponsor has announced that he will attempt to add this bill to the next House-passed tax measure reaching the Senate. Thus, there apparently will be only 2 days of public hearings before the Finance Committee on this proposal, following very short advance notice, and no hearings at all before the House Ways and Means Committee. This seems to us a highly undesirable means of considering what would amount to repeal of a key code provision which has now been in effect for over 10 years.

DESIRABILITY OF EFFECTIVE INCENTIVE FOR CORPORATE EXECUTIVES WAS REASON FOR ENACTMENT OF RESTRICTED STOCK OPTION PROVISION

As this committee is well aware, the tax treatment of employee stock options had aroused considerable controversy prior to enactment of the current code provisions relating to restricted stock options. In *Commissioner* v. *Smith* (324 U.S. 177 (1945)) the Supreme Court required an employee to include in his gross income the difference between the price at which he purchased stock under an employee stock option and the market value of the stock at the time the option was exercised. This decision led to Treasury regulations in the following year under which the general rule of the *Smith* case was in effect applied to all employee stock options. Subsequently, there were recommendations from a number of taxpayer groups that tax not be imposed on employee stock options until ultimate sale of the optioned stock. The House in 1948 approved special tax treatment but only for certain narrowly defined employee stock options, termed "restricted" stock options. This approach was approved in 1950 by this committee, added to the Senate version of the Revenue Act of 1950, and accepted by the House in conference.

The restricted stock option provision of that act, section 130A of the 1939 code (which is now, with certain amendments, sec. 421 of the 1954 code), was approved by this committee with the following explanation, which now seems to merit renewed emphasis.

"Your committee's bill (sec. 220) establishes a new set of rules for the tax treatment of certain employee stock options. Such options are frequently used as incentive devices by corporations who wish to attract new management, to convert their officers into 'partners' by giving them a stake in the business, to retain the services of executives who might otherwise leave, or to give their employees generally a more direct interest in the success of the corporation.

"At the present time the taxation of these options is governed by regulations which impede the use of the employee stock option for incentive purposes. Moreover, your committee believes these regulations go beyond the decision of the Supreme Court in *Commissioner* v. *Smith*, (324 U.S. 177 (1945)). The resulting uncertainty as to whether these regulations are in accordance with the law is an additional reason for legislative action at the present time."

We contend that these basic reasons which led to the adoption of special tax treatment for restricted stock options in 1950 are equally valid today.

Consideration of S. 1625, together with the remarks of Senator Gore at the time of its introduction (Congressional Record, Apr. 14, 1961, at p. 5596), raises for legislative review a variety of questions. Is the restricted stock option a means of unjust enrichment by and for "the insiders"? Is it unfair to ordinary shareholders? Does it result in a serious revenue loss to the Treasury and an unequal distribution of the burden of taxation? What of its effects on the small business? Finally, is the continued special tax treatment of the restricted stock option in the public interest?

These are entirely proper questions for study and deserve the committee's most careful consideration. We are constrained, however, to observe that the haste with which this hearing was called and the very brief period which so far has been allotted to these hearings seem to us hardly conducive to the kind of exhaustive study which they require. Suppose we reverse the order of the questions raised above and consider first the ultimate question—is the current special tax treatment provided the restricted stock option in the public interest? We believe it is.

It is by now commonplace that among the economic resources of the United States none is more scarce than managerial talent. Since corporations provide the bulk of jobs in the United States and furnish a major share of all revenue to the Federal Government, it seems wholly in the public interest to provide legislatively a tax framework for effective use of a device permitting corporations to attract and retain the best possible managerial talent.

If we accept this proposition as true, it becomes necessary only to inquire as to the efficacy of the stock option device and as to its effects upon shareholders, revenue, small business, etc. We turn now to brief consideration of these questions.

Stock options permit managers to acquire a proprietary interest in their companies.—The great majority of business executives are not men of accumulated wealth. Although most would like to acquire a proprietary interest in the corporations which they serve, generally they lack the capital necessary to purchase more than a nominal amount of the corporation's stock. The problem, therefore, has been to provide these executives with a means by which they might acquire such a proprietary interest and the restricted stock option has proven to be suited to this purpose.

As emphasized by Prof. Dan Throop Smith and others, the realization of a corporation's full growth potential requires long-term investment, substantial and continuing research and development, maximum productivity over the longer term, quality products, and competitive prices. Such objectives are clearly in the long-term interests both of shareholders and of the Government, since their realization will tend to increase the value of shares held and will tend to increase both employment and revenues from the standpoint of the Government. But that cannot be realized by management policies oriented largely, if not wholly, to the maximization of profit—for purposes of bonus or profit sharing—in the short run. Obviously, some means must be found to bring about coincidence of interest between corporate owners and corporate managers. The restricted stock option provides that means.

We should add that there is no intention of suggesting or even implying that corporate executives would not otherwise act in good conscience for what they consider the best interests of their corporate employers. But in the absence of a clear alinement of interests between owners and managers—such as the stock option produces—there is apt to be a concentration upon short-run sales and profit objectives.

The effectiveness of the stock option in achieving this identity of interests between shareholder and corporate manager is well put by Mr. Henry Ford II, chairman of the Ford Motor Co., in his article in the July-August 1961 issue of the Harvard Business Review entitled "Stock Options in the Public Interest." Mr. Ford had this to say:

"1. It represents an opportunity for gain that is especially sought after, but that will be realized only if the stockholders benefit.

"2. It establishes a proprietary interest which alines the executive's personal interests closely with those of stockholders and thus, from their standpoint, affects favorably his day-to-day business actions and decisions. Specifically, it strengthens his interest in the long-term growth and health of the organization."

Importance of stock options to small companies.—This committee has heard testimony regarding the important role that stock options can play in helping a small corporation compete successfully against larger rivals. We have no wish to repeat this testimony, but its main features deserve reemphasis because we think they are vitally important to the committee's consideration of S. 1625.

In general, a small corporation which has potential for future expansion may find the use of restricted stock options a nearly indispensible method of competing effectively with its larger rivals in securing and retaining effective management. The stock option enables the small corporation to offer a substantial stake in the business to its key executives who might well be lured away by larger corporate rivals who are in a position to offer considerably higher salaries. It is of course true that such rivals are also able to offer stock options, but the key point here is that the interest which may normally be acquired in a smaller corporation through use of stock options is ordinarily much greater proportionately and in a proprietary sense than the interest which may be similarly acquired in larger corporations. This being the case, it hardly seems to be a propitious time for the Congress to be considering repeal of the restricted stock option provisions of the Code, an action which seems much more likely to hinder rather than to help smaller business, to the detriment of competition generally.

We are very impressed by the testimony of Dr. Herbert W. Robinson, president of CEIR, Inc., presented during the current hearings, and particularly in the following observation:

"CEIR could not have obtained the highly trained professional and executive talent which is essential to a service organization such as ours on the basis of

salary alone. Nor would our company have benefited from the many hours of unpaid overtime and that extra devotion to duty which our key employees have contributed to our company because they owned a stake in its success. This was made possible only because we could offset the relatively low salaries which CEIR could afford, coupled with an uncertain future in a new company, with employee stock options and the opportunity to become owners of increasingly valuable stock in their own company if it prospered."

REVENUE CONSIDERATIONS NEED CAREFUL ANALYSIS

In introducing S. 1625 Senator Gore stated that enactment of his bill is likely to save at least $100 million in revenue. We feel that any such tax savings are quite unlikely. Indeed, the revenue impact of the restricted stock option privilege is in our judgment widely misunderstood.

Section 421 of the Internal Revenue Code covering restricted stock options specifically disallows the cost of employee stock options as a corporate business expense deduction. Accordingly, a corporation must pay 52 cents in taxes for each dollar of compensation paid to its executives in the form of stock options, where the 52 cents might be saved by the corporation from a tax standpoint through use of other types of employee compensation which are tax deductible. From the standpoint of the executive, the recipient of the option privilege, he will in most cases ultimately be required to pay 25 cents in taxes on the stock option dollar so that the total tax paid by corporation and individual on the stock option dollar is in the range of 77 cents.

The only apparent revenue loss through the existence of section 421 comes into play when the corporate executive receiving the stock option is in an individual income tax bracket higher than 77 percent. We suggest that the corporate executive receiving a restricted stock option is as likely, and probably more likely, to fall in a lower bracket.

Moreover, it would appear that Senator Gore's analysis of revenue considerations not only ignores the tax deductibility factor but also is based on the assumption that, in the event tax treatment of the restricted stock option privilege is changed in the law, restricted stock options will continue to be as widely used as under present circumstances.

In general, it is our conclusion that at the least Senator Gore's position on revenue impact is greatly overstated; it is entirely possible that there would be a net tax loss to the Government flowing from the statutory change he proposes.

In this connection may we refer to the extensive statement of Senator Carl Curtis of Nebraska in the Senate on July 20 (Congressional Record at p. 12096) which deals with the entire question of restricted stock options including the revenue issue.

THE PROBLEM OF THE CLOSELY HELD CORPORATION IN USING THE RESTRICTED STOCK OPTION—A SUGGESTION FOR CONGRESSIONAL STUDY

It has been noted in the current hearings before the committee that it is very difficult for a closely held corporation to establish a market value on its stock in such a way as to anable it to meet the qualification requirements for restricted stock option treatment. We concur in recommending that the committee give special consideration to this problem. The restricted stock option is in our judgment, as we have indicated above, a very effective competitive device for smaller business. If it is possible to make restricted stock options more generally available for use by closely held corporations which more frequently than not fall in the smaller size category we feel that Congress will have taken a most constructive step in the stock option area.

Some problems connected with the restricted stock option.—In his testimony in these hearings, Mr. Michael Waris, Jr., associate tax legislative counsel of the Treasury Department, has called attention to a number of problems in the stock option area to which the Treasury is now giving attention and which he suggests should receive full consideration before any affirmative action is taken on a measure as sweeping as S. 1625. We agree with Mr. Waris' suggestion that additional study is required on certain current problems concerning restricted stock options as well as the likely effect of enactment of a full repeal of the current code provision.

For example, it would seem to us useful in any full consideration of S. 1625 or similar legislation to consider the holding period for corporate shares, the establishment of option price for shares of closely held companies, and the repricing of stocks on which options are offered.

This concludes our statement on S. 1625. If we can provide any further information please let us know.

Respectfully,

CHARLES STEWART, *President.*

STATEMENT OF THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS ON SENATE BILL 1625 SUBMITTED BY ANDREW J. BIEMILLER, DIRECTOR, DEPARTMENT OF LEGISLATION

The AFL-CIO wishes to be recorded as being in complete support of Senate bill 1625, introduced by Senator Albert Gore of Tennessee. This bill would amend the Internal Revenue Code of 1954 so as to terminate the special tax treatment now accorded certain management executives.

Stock options provide unwarranted privileges for the few to aid their rapid enrichment at the expense of ordinary employees, other stockholders, and American taxpayers generally. The stock option privilege is morally indefensible. It should be terminated immediately.

Stock option plans are a classic example of how the preferential treatment of capital gains income has been exploited to favor upper-income taxpayers. Under these plans, corporation employees—usually high-ranking executives—are permitted to buy stock in the corporation at a favorable price, normally below market value. If the stock is then held for 6 months, the profit on a subsequent sale is taxable at the lower capital gain rates (a maximum of 25 percent).

One special advantage of the stock option plan is that the holder of the option does not have to exercise it at any one time. He can wait to see whether the price of the stock goes up. Then he can utilize his option at a price well below the market price and thus obtain a handsome profit without any of the risk normally associated with buying stock.

Another advantage is that he needs to exercise only part of his option at any one time. For example, an individual could utilize part of his option, and after 6 months sell the stock he has so acquired at a profit. He could then use this profit to buy the additional shares of stock due him under his option.

To cite a specific case, the Ford Motor Co. in 1953 granted its chairman an option to buy 6,000 shares of Ford stock at $315 a share. Between then and 1958, a stock split of 15 for 1 increased his option to 90,000 shares at $21 a share. He bought the shares at this price, for a total investment of $1,890,000. On December 31, 1959, these 90,000 shares were worth $6.3 million more than their cost. If he sold the shares at this point, his profit, after taxes, would average out to more than $670,000 a year for the period since the option was granted. He would have had to earn a salary of over $5 million a year to have that much left after taxes.

To cite another, the president of Goodyear Tire & Rubber Co. was also well treated under his company's stock option plan. In 1950 he was given an option on 9,000 shares at $59 a share. From 1952 to 1955 he exercised his option, paying a total of $531,048. By the end of 1958, because of stock splits and stock dividends, the shares he purchased were the equivalent of 126,430 shares, worth $5,284,732 more than he paid for them. If he had sold all 9,000 shares at that time he would have netted $3,963,549 after taxes. His average profit for the 9-year period since the option was granted would have been $440,394 a year. In order to have this much left from his salary after taxes, he would have had to earn more than $3 million a year.

Nor are Ford and Goodyear the only companies that treat their executives well. More than half the comapnies listed on the New York Stock Exchange, and many unlisted companies, have such stock option plans. These are usually available only to upper income individuals, and cost the Treasury an estimated $100 million a year. Some corporations, such as the American Crystal Sugar Co., even provide interest-free loans to executives for their stock option purchases.

Even if the stock is not held long enough to benefit from the cut-rate capital gains tax, stock options still permit large profits with no risk. In an article in the July 1959 issue of Harper's Magazine, Bernard Nossiter pointed out that "U.S. Steel last year gave 120 of its executives options on 151,000 shares at $55. This spring, the stock had risen $40 a share above this. Any time a top steel executive needed cash, he picked up his telephone, told the company treasurer to issue him a few thousand of his optioned shares, and told his broker to sell them at the market price. Thus, our executive cleared $40 a share with two telephone calls—and without investing a cent of his own money."

What if stock prices go down after the option is issued? This happened to the Chrysler Corp. Chrysler executives naturally did not use the options at the higher prices. Instead the corporation issued them new options at a price that permitted them to make a profit. Alcoa—the Aluminum Corporation of America—is another company that did the same. In 1956, Alcoa granted its executives an option to purchase 198,000 shares at $117.25 a share. The market price of the stock dropped to $76 in 1957 and continued to decline in 1958. In March of that year, a committee comprising the six highest-paid directors and officers of Alcoa voted to exchange the old options for new ones at a price of $68.50 a share. Four of the six members of this committee were in a position to benefit from this exchange.

The rationalization for this favored treatment for stock options is that they are not income, but rather are given to provide executives with an interest in the well-being of the corporation and an incentive to improve its profits. Presumably the executives' salaries also provide them with interest and incentive—yet these are subject to ordinary income taxes.

Stock options are particularly open to abuse because for all practical purposes they are voted into existence by those who benefit from them. Although such plans have to be approved at some point by the stockholders, this approval is usually routine. Some stockholders, however, have vigorously opposed stock option plans, because the exercise of stock options at less than the market price by the corporation's executives reduces the share of the business held by each of the other stockholders. When the shares are sold to executives at less than the market price, all the other shareholders suffer a loss.

In addition to the way stock options bleed the equities of the other stockholders, this tax gimmick also unconscionably plays favorites among employees.

While millions of wage and salary earners are required to pay taxes on their compensation at the regular progressive Federal income tax rates, a favored few executives—who are already among the best off—enjoy an unethical and unjustified legal tax shelter.

Finally, the estimated $100 million which is mulcted from the Federal Treasury by stock option recipients each year has to be made up by levies imposed upon the rest of the taxpaying population.

The stock option privilege is an outrageous piece of class legislation. It should never have been allowed to appear on the statute books a decade ago. Now, it is high time to end this monstrosity and take it off.

Senator GORE. The committee stands adjourned.

(Whereupon, at 3:45 p.m., the hearing was adjourned, subject to the call of the Chair.)

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