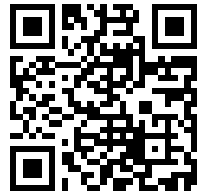

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Stock Option and Stock Purchase Plans ☆ ☆ ☆ ☆ ☆

SALARY STABILIZATION BOARD

Stock Option and Stock Purchase Plans

U.S. The Report of a
Special Panel to the
Salary Stabilization Board
October 23, 1951

Members of Panel

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DraftKings, Ex. 1039, p. 6

years. In order to avoid borrowing or tying up of capital, the option holder will be inclined to postpone exercise of his option until some time toward the close of the period during which he has the power of exercise. Likewise it is probable that he will hold the stock, once acquired, beyond the minimum two year period necessary to obtain the benefits of section 130-A. Such extended holding will accord with the intent, as evidenced in proxy statements on file with the Securities and Exchange Commission, to increase the proprietary interest of the option holder in his corporation. The likelihood of such extended holding is frequently implemented by the understanding with the optionees that, circumstances permitting, the stock will be held as an investment.

"The time of disposal is also affected by the clarification of the tax law. Prior to the passage of section 130-A, the Bureau of Internal Revenue took the position that the optionee could receive taxable income (based upon the spread between option and market price) at the time of exercise. The executive's need for cash to pay such tax was a factor inducing early disposal of the stock. Baker, *Stock Options for Executives*, 19 Harvard Business Review (1940) 121. This factor was removed when Congress provided that no tax would be incurred upon the exercise of a restricted option in conformity with section 130-A.

The present effect of the exercise of restricted options, and the only possible one for at least two years and probably longer if section 130-A is complied with, is to reduce cash in the hands of consumers, which is plainly anti-inflationary" (Ex. 10, p. 5-6).

B. The point that the employee, in taking up his stock under a restricted stock option, is likely to pay for his stock out of savings derived from current earnings rather than by borrowing, and to hold it, was emphasized as follows:

"The grant of such an option places no moneys in the hands of the employee. On the other hand, the holder of a restricted stock option will in many, and probably in most, cases be under pressure to accumulate funds which will enable him to exercise the option. Thus the granting of such an option will promote the accumulation rather than the dissipation of individual savings. If the optionee has no substantial outside resources—and in this era of high taxes it is a fair guess that most corporate employees are not in this position—the only practical way for him to raise the bulk of the option price will be by savings. He cannot go to his bank and borrow all of it, even if the stock has gone up to such an extent that the banker would consider the spread in excess of the option price a safe margin. This is because of regulation U. If a loan is to be collateralized by stock a bank at present may not lend more than 25 percent of current market value of the stock if, as in the case of International Minerals & Chemical Corporation, it is listed on a national securities exchange" (Tr. 223-224).

In contradiction of the foregoing point as to the deterring effect of regulation U in limiting bank loans on the stock to be acquired, it was noted that "a private loan" might be accomplished in lieu of a proscribed bank loan, or part of the stock covered by option might be sold at a profit sufficient to purchase more of the stock (Tr. 417).

C. Like views as to the anti-inflationary consequences of restricted stock options were emphasized with respect to option plans involving installment payroll deductions and postponement of employee acquisition of his stock for the periods that would entitle him to the tax advantages of section 130-A (Tr. 290-293).

D. The view also was advanced that restricted stock option plans may, or will tend to, reduce the pressure on the corporate employer to increase cash payments in one of their many forms, and thereby serve the purposes of the Defense Production Act. (Tr. 135, 203, 207, Ex. 21, p. 2). Another view was expressed, however, that the given restricted stock option plan would have no bearing upon salaries or increases in salaries (Tr. 313).

But is not the employee going to press for more cash compensation to help pay for his investment in his company? "I do not think so" (Tr. 212).

E. The noninflationary status of the restricted stock option was advanced in another way—as involving very little more than "a hope"; and it cannot be used to buy any consumer goods.

That "it is really a hope for a future profit. That is all the restricted stock option can mean on the date that it is granted, that Mr. Employee, who receives it, can go home to his wife and children and say, 'I got a stock option today. There is not a thing in it that provides me a basis to buy you any more television sets, any other goods, any more food at all, but it does contain a hope that if my employer corporation is successful, if the value of the stock covered by my option enhances marketwise within the period in which I may exercise it, there is the possibility, provided I can raise the necessary cash

to make the payments, that we shall have made a sound investment out of our savings'. That is about what it means, as I see it" (Tr. 190).

F. It was further urged that a restricted stock option plan is not inflationary even though the employee eventually acquires and then sells his stock for a profit. His profit is paid for by the purchaser of the stock and the level of consumer purchasing power is not enhanced.

"Where the employee exercises it, he pays money to the employer. His purchasing power is reduced. He is then engaged in a form of saving rather than spending. If later he sells the stock at a profit, then his purchasing power is increased.

"However, correspondingly, the purchasing power of the purchaser is decreased. It is no different from an ordinary sale on the Stock Exchange, and there is no overall increase in the purchasing power of the consumer.

"True, it may result in a transfer of cash from a person who did not intend to use it for consumer goods to a person who does, but it may equally work the other way. In any case, it is not significantly inflationary" (Tr. 153).

Of like tenor:

"The exercise of a stock option represents payment from moneys otherwise available for civilian consumption goods into a capital investment. If and to the extent that such investment is retained upon the exercise of the option, there can be little doubt but that the effect is deflationary. The resale of such stock can likewise have no inflationary effect to the extent of the amount thereof equivalent to the option price, since it merely reimburses the option holder with funds that he possessed and had available for consumption of goods anyway. Nor is the gain above his option price upon any resale necessarily inflationary since such gain derived from funds otherwise available for civilian consumption merely leaves those funds still so available although in new hands.

"There is, of course, the possibility that the funds of the buyer paid to the option holder would have been channelled into investments anyway, but such an assumption could be made also in the case of any sale of a capital investment. Even if this assumption be occasionally true in fact; the seller must in addition apply the proceeds to consumption goods before there is a net inflationary effect. These risks are inherent if sales and exchanges of capital investments are permitted free of price controls as they are now. Yet it is necessary to run these risks in order to maintain liquidity for capital investments and attract purchasing power to capital. The main determinant should be whether the consequential effects of stock options will be more probably to maintain and enhance the investment of capital" (Ex. 6, Tr. 523-524).

G. The point that the grant and exercise of the restricted stock option do not lend themselves to inflationary use by speculation was supported by gathering together the following considerations which would deter the employee from using the option for speculative purposes: (1) the required 2 years and 6 months holding periods to earn the tax benefits of 130-A and (2) the restraints of section 16 (b) of the Securities and Exchange Act of 1934 upon the privileges of officers and directors to speculate in the purchase and sale of the stock of their corporation.

"The argument could be made that a restricted stock option can be exercised in an inflationary manner because there is no requirement in the statute that stock acquired under the option may be disposed of only 2 years after the granting of the option or that it must be held for 6 months after the option is exercised. The optionee, it might be said, could, shortly after the granting of the option, take down part of the optioned stock, sell it, immediately use the proceeds to take down an additional block, sell that and repeat this procedure until he has disposed of the stock covered by his option. This argument necessarily assumes that the optionee is willing to pay tax on his gain at ordinary rates. But it overlooks the fact that if he is a director or officer of the employer corporation and if the stock of that corporation is listed on a national securities exchange, another provision of law, section 16 (b) of the Securities and Exchange Act of 1934, bars such a scheme. That section effectively stops an officer or director from taking a profit on stock of his company which he has held for less than 6 months.

"The further assumption that the optionee would be willing to forego the capital gains tax treatment he enjoys if he observes the 2 years and 6 months provisions of section 130-A of the Internal Revenue Code is, rather obviously, quite unrealistic. Therefore, it might be argued that he will observe these provisions, but will use the proceeds of the first sale immediately to pick up another block under his option, hold that for six months, sell, and repeat the procedure. Thus if he exercised the option each time with respect to 25 percent of his allotment and made the first sale in January 1953, he could complete the operation by July 1954. Even this, however, is impossible

in the case of an optionee who is an officer or a director by reason of the mentioned section 16 (b) of the Securities and Exchange Act which applies not only to a purchase followed by a sale, but as well to a sale followed by a purchase. Six months must intervene between each transaction, which means that at least a full year must intervene between each partial exercise of the option. The initial exercise must be followed by a 6 months waiting period before sale, and that sale must be followed by an equally long waiting period before the option can again be exercised. These additional considerations further demonstrate the noninflationary nature of restricted stock options" (Tr. 224-226).

Employees acquiring only a few shares would be especially deterred from quick "ins" and "outs" of the market by the costs of selling their stock. "In the case of employees holding relatively few numbers of shares, it is believed that the expense of brokerage fees, stock transfer taxes and the increased income taxes and loss of prestige within their department will act as a deterrent to such immediate exercise" (Tr. 338).

H. The point also was advanced that the major purpose of the Defense Production Act, is so far as it relates to the stabilization of wages, salaries, and other compensation, is "to prevent increase in costs which will constitute or create pressure on ceiling prices. It also is to prevent inflation." A restricted stock option does not involve any such costs and, "therefore, cannot constitute a pressure on ceiling prices. It cannot constitute a basis for the employer asking to have his ceiling prices increased" (Tr. 152-153).

In line with this general view reference also was made to the intent of the Defense Production Act of 1950 to tie wage control to establish price control and that the use of restricted stock options is not prejudicial to the declared objectives of that program. The Report of the Senate Committee on Banking and Currency in regard to this intent (S. Rept. No. 2250, 81st Cong., 2nd sess. p. 29) was quoted in this connection as follows:

"The degree of wage control required must be in a general way parallel the degree of price control imposed upon the economy. At the very minimum, there must be sufficient wage control to protect established price control, and to deal equitably with those establishments whose operations are subject to price control. Selective price controls call for selective wage controls. Broad price control, particularly when sufficiently widespread to require application at the retail level, calls for broad wage controls. Wage and price control must go together in the interests of equity to both employer and employee. To the employee, price control is a necessary prerequisite for the imposition of wage control; it is a guaranty that prices will in fact be stabilized when his wage is stabilized. To the employer, wage control is a prerequisite for the imposition of price control; it is a guaranty that his wage-costs will not be unreasonably increased at a time when he cannot increase his prices.

"Tying price and wage controls thus together, section 402 (b) of the bill authorizes the President to impose selective wage control following the imposition of selective price control. This section also requires that the President shall impose wage controls where wage increases would require increases in established price ceilings or would impose undue burden on sellers operating under established price ceilings" (Ex. 16, p. 13-14).

With this declared intent of the program, it was urged that restricted stock options fall outside its objectives or concern.

"Neither the granting nor the exercise of a restricted stock option increases the costs of the material or service that is manufactured or furnished by the corporation which grants the option. On neither occasion does the employer pay out any money to the employee to whom the option is granted. The granting or exercise of the option could not be made the basis of a request by the employer for an increase in the ceiling price of the material or service which is manufactured or furnished by such employer. It is submitted, therefore, that the granting or exercise of such option does not fall within the purpose of title IV of the Defense Act, and that such title does not require or authorize the President to impose any control over the granting or exercise of such an option" (Ex. 16, p. 14).

1. Contrary to the prevailing tenor of the foregoing opinion as to the non-inflationary effect of plans for restricted stock options under section 130-A of the International Revenue Code, various considerations were emphasized.

(1) Section 130-A deals with tax favors to be accorded under certain conditions, but it does not require employees to adhere to them. An employee is privileged to disregard them and pay his taxes.

(a) That law "merely states the conditions under which taxation of a transfer of stock or an option on stock is not taxes"; that the statute "in no sense of the word

requires that the employee conform to all of the restrictions"; that if the employee chooses to sell his stock one day after he gets the option and takes up the stock, he may do so and pay his tax;

(b) When such employee does so at a gain after tax it has an inflationary effect; and

(c) "the mere fact that an opportunity to get capital gains treatment is afforded to the executive or the employee has nothing to do whatsoever with whether or not conformance with those tax restrictions or non-conformance is inflationary" (Tr. 162, 163).

Moreover, "I do not think the Board could achieve the limitation of inflation just by accepting 130-A as it stands, but I think that there are lots of executives who would be very glad to get the stock options and sell them out and pay the ordinary income tax on the gain, take the cash and let the credit go" (Tr. 166).

By way of summary of the foregoing: 130-A neither hinders nor helps much in determining the inflationary effect of stock options, otherwise than as "the advantage of capital gain treatment might in most cases tend to have the employee defer the sale of his stock for 2 years after the date of the option" (Tr. 164).

(2) Furthermore: Even if section 130-A is followed by the employee and the stock is held for the prescribed 2 years, "that still may have an inflationary effect, particularly since in that situation, the gain which may reflect a general inflationary tendency in the economy would be taxable at the low rate of 25 percent" (Tr. 164).

(3) The use of stock options also was cited for its inflationary example to labor. Such use may excite further demands for increases in salaries and wages.

"I think that your panel must look primarily at stock options as to what effect they are going to have upon the country as a whole, not from the direct inflation that may be caused by the issuance of these options, but from the economic and sociological effect that they are going to have or about to have upon labor, in the plans.

"The point was just made, and it is a good one, that not a union official has appeared here because they certainly would like to see these stock option plans continued; it just gives them another log to throw upon the fire" (Tr. 455).

And: "As long as wage-earner fringe benefits are stabilized, it seems as a matter of fairness that executive fringe benefits should also be stabilized. Aside from the question of fairness, it would seem only prudent at this time to avoid taking any action which might be construed by labor as granting preferential treatment to executives" (Ex. 3, Tr. 503).

(4) It was further urged that a long-term trust qualifying under section 165-A of the Internal Revenue Code would tend much more than a restricted stock option plan to stimulate employees to maintain long-term stock holdings in the company and free from inflationary consequences.

"We do not believe that stock options are necessarily the best means of providing stock participation for employees. Section 130-A is helpful chiefly to the employee who does want to sell, and who does want to take his cash at a capital gain rate. For the employee who wants to buy and really stay in, the stock bonus plan or the creation of an executive investment company with long term participation is much more advantageous from a tax point of view than the exercise of a stock option under 130-A" (Tr. 167-168).

Also: "Remember, that the most important provisions of 130-A come into play only when the stock is sold * * *. If 130-A was directed only to the employee who wanted to hold his stock, it could accomplish that end by merely saying that there is to be no taxable gain when the option was taken up, treated more or less as a tax-free exchange, like when you have mergers between corporations.

"In other words, postponing the taxable event until the stock was sold. However, 130-A went further than that. It not only postponed the tax, it went on to say that if you meet the terms of this section, then when you do sell the stock, you pay only the capital gains tax.

"It is that provision which I think renders 130-A ineffective as an anti-inflationary guide to this Board" (Tr. 171-172).

J. It also was suggested that section 130-A may be geared to function chiefly—both in terms of number of employees and in terms of dollars involved—in behalf of relatively few corporate executives, and facilitate speculation and inflation. "I think 130-A is definitely for the higher echelon of executives," but "I do not think that is a criticism of it. I think top management gets a pretty tough deal, certainly if you compare top management in the United States with top management in Russia, top management in the United States gets the short end of the stick" (Tr. 169, 171).

A position somewhat contrary to the last one was voiced by another witness. Upon inquiry by the panel, whether 130-A is geared primarily to accommodate the higher earning employees rather than lower earning employees, and whether back of that there was real possibility or probability of quick "ins" and "outs" in the exercise of options