108TH CONGRESS
2d Session
HOUSE OF REPRESENTATIVES
REPT. 108–609
Part 1

STOCK OPTION ACCOUNTING REFORM ACT

JULY 15, 2004.—Ordered to be printed

Mr. OXLEY, from the Committee on Financial Services, submitted the following

R E P O R T

[To accompany H.R. 3574]

[Including cost estimate of the Congressional Budget Office]

The Committee on Financial Services, to whom was referred the bill (H.R. 3574) to require the mandatory expensing of stock options granted to executive officers, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

CONTENTS

	Page
Amendment	1
Purpose and Summary	4
Background and Need for Legislation	4
Hearings	7
Committee Consideration	7
Committee Votes	8
Committee Oversight Findings	12
Performance Goals and Objectives	12
New Budget Authority, Entitlement Authority, and Tax Expenditures	12
Committee Cost Estimate	12
Congressional Budget Office Estimate	12
Federal Mandates Statement	14
Advisory Committee Statement	14
Constitutional Authority Statement	14
Applicability to Legislative Branch	14
Section-by-Section Analysis of the Legislation	14
Changes in Existing Law Made by the Bill, as Reported	17

AMENDMENT

The amendment is as follows:

Strike all after the enacting clause and insert the following:

SECTION 1. SHORT TITLE.

This Act may be cited as the "Stock Option Accounting Reform Act".

SEC. 2. MANDATORY EXPENSING OF STOCK OPTIONS HELD BY HIGHLY COMPENSATED OFFICERS.

Section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m) is amended by adding at the end the following:

"(m) MANDATORY EXPENSING OF STOCK OPTIONS.—

"(1) NAMED EXECUTIVE OFFICER.—As used in this subsection, the term 'named executive officer' means—

"(A) all individuals serving as the chief executive officer of an issuer, or acting in a similar capacity, during the most recent fiscal year, regardless of compensation level; and

"(B) the 4 most highly compensated executive officers, other than an individual identified under subparagraph (A), that were serving as executive officers of an issuer at the end of the most recent fiscal year.

"(2) IN GENERAL.—Subject to paragraph (4), every issuer of a security registered pursuant to section 12 shall show as an expense in the annual report of such issuer filed under subsection (a)(2), the fair value of all options to purchase the stock of the issuer granted after December 31, 2004, to a named executive officer of the issuer.

"(3) FAIR VALUE.—

"(A) IN GENERAL.—The fair value of an option to purchase the stock of the issuer that is subject to paragraph (2) shall—

"(i) be equal to the value that would be agreed upon by a willing buyer and seller of such option, who are not under any compulsion to buy or sell such option; and

"(ii) take into account all of the characteristics and restrictions imposed upon the option.

"(B) PRICING MODEL.—To the extent that an option pricing model, such as the Black-Scholes method or a binomial model, is used to determine the fair value of an option, the assumed volatility of the underlying stock shall be zero.

"(4) EXEMPTIONS.—

"(A) SMALL BUSINESS ISSUERS.—This subsection shall not apply to an issuer, if—

"(i) the issuer has annual revenues of less than $25,000,000;

"(ii) the issuer is organized under the laws of the United States, Canada, or Mexico;

"(iii) the issuer is not an investment company (as such term is defined under section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3));

"(iv) the aggregate value of the outstanding voting and non-voting common equity securities of the issuer held by non-affiliated parties is less than $25,000,000; and

"(v) in the case of an issuer that meets the criteria in clauses (i) through (iv) and is a majority-owned subsidiary, the parent of the issuer meets the requirements of this paragraph.

"(B) DELAYED EFFECTIVENESS.—The requirements of this subsection shall not apply to an issuer before the end of the 3-year period beginning on the date of the completion of the initial public offering of the securities of the issuer, and shall only apply to an option to purchase the stock of an issuer granted after such date.".

SEC. 3. PROHIBITION ON EXPENSING AND ECONOMIC IMPACT STUDY.

(a) PROHIBITION.—Section 19(b) of the Securities Act of 1933 (15 U.S.C. 77s(b)) is amended by adding at the end the following:

"(3) PROHIBITION ON EXPENSING STANDARDS.—

"(A) IN GENERAL.—The Commission shall not recognize as 'generally accepted' any accounting principle relating to the expensing of stock options unless—

"(i) it complies with the requirements of subparagraph (B); and

"(ii) the economic impact study required under section 3(b) of the Stock Option Accounting Reform Act has been completed.

"(B) REQUIREMENTS.—A standard referred to in subparagraph (A) shall require that—

"(i) if an option to purchase the stock of an issuer that is subject to the requirements of section 13(m) of the Securities Exchange Act of 1934 is exercised—

"(I) any expense that had been reported under that section 13(m) with respect to such option shall be recomputed as of the date of exercise and shall be equal to the difference between the price of the underlying stock and the exercise price; and

"(II) to the extent the recomputed amount differs from the amount previously reported under section 13(m) with respect to such option, the difference shall be reported in the fiscal year in which the option is exercised as a reduction or increase, as the case may be, of the total expense required to be reported under that section 13(m) during that fiscal year;

"(ii) if an option to purchase the stock of an issuer that is subject to the requirements of section 13(m) of the Securities Exchange Act of 1934 is forfeited or expires unexercised, any expense that had been reported under that section 13(m) with respect to such option shall be reported in the fiscal year in which the option expires or is forfeited as a reduction of the total expense required to be reported under that section 13(m) during that fiscal year; and

"(iii) to the extent that any reduction required under clause (i) or (ii) exceeds total option expenses for any fiscal year, such excess shall be reported as income with respect to options to purchase the stock of the issuer.".

(b) ECONOMIC IMPACT STUDY.—Not later than 1 year after the date of enactment of this Act, the Secretary of Commerce and the Secretary of Labor shall conduct and complete a joint study on the economic impact of the mandatory expensing of all employee stock options, including the impact upon—

(1) the use of broad-based stock option plans in expanding employee corporate ownership to workers at a wide range of income levels, with particular focus upon non-executive employees;

(2) the role of such plans in the recruitment and retention of skilled workers;

(3) the role of such plans in stimulating research and innovation;

(4) the effect of such plans in stimulating the economic growth of the United States; and

(5) the role of such plans in strengthening the international competitiveness of businesses organized under the laws of the United States.

SEC. 4. IMPROVED EMPLOYEE STOCK OPTION TRANSPARENCY AND REPORTING DISCLOSURES.

(a) ENHANCED DISCLOSURES REQUIRED.—Not later than 180 days after the date of enactment of this Act, the Commission shall, by rule, require each issuer filing a periodic report under section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)) to include in such report more detailed information regarding stock option plans, stock purchase plans, and other arrangements involving an employee acquisition of an equity interest in the company. Such information shall include—

(1) a discussion, written in "plain English", in accordance with the Plain English Handbook published by the Office of Investor Education and Assistance of the Commission, of the dilutive effect of stock option plans, including tables or graphic illustrations of such dilutive effects;

(2) expanded disclosure of the dilutive effect of employee stock options on the issuer's earnings per share;

(3) prominent placement and increased comparability and uniformity of all stock option related information;

(4) the number of outstanding stock options;

(5) the weighted average exercise price of all outstanding stock options; and

(6) the estimated number of stock options outstanding that will vest in each year.

(b) DEFINITIONS.—As used in this section:

(1) COMMISSION.—The term "Commission" means the Securities and Exchange Commission.

(2) ISSUER.—The term "issuer" has the meaning provided in section 2(a)(7) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201(a)(7)).

(3) EQUITY INTEREST.—The term "equity interest" includes common stock, preferred stock, stock appreciation rights, phantom stock, and any other security that replicates the investment characteristics of such securities, and any right or option to acquire any such security.

SEC. 5. PRESERVATION OF AUTHORITY.

Nothing in this Act shall be construed to limit the authority over the setting of accounting principles by any accounting standard setting body whose principles are

recognized by the Securities and Exchange Commission under section 19(b)(1) of the Securities Act of 1933 (15 U.S.C. 77s(b)(1)).

PURPOSE AND SUMMARY

H.R. 3574, the Stock Option Accounting Reform Act, will require the mandatory expensing of stock options granted to executive officers. Specifically, the bill will preserve broad-based employee stock option plans and address the economic implications of stock option expensing by prohibiting the Securities Exchange Commission (SEC or Commission) from recognizing as generally accepted an accounting principle that requires the expensing of employee stock options unless an economic impact study is completed and a "truing-up" mechanism is provided. The bill imposes a new requirement that public companies report as an expense on their income statements stock options issued to the company's chief executive officer and the next 4 highest compensated employees. Further, the bill mandates that when reporting those stock option expenses, companies use a specific accounting formula that assumes that stock prices do not fluctuate. H.R. 3574 exempts small businesses from expensing stock options altogether. In addition, newly public companies avoid expensing options for top executives in the initial 3 years.

BACKGROUND AND NEED FOR LEGISLATION

In the bull market of the 1990s, employee stock options were widely celebrated as a vital instrument in the growth of the high-tech sector. Employee stock options give the holder a right to buy shares at a fixed price over a fixed period of time. If the value of the company's stock rises, an employee can exercise the stock option and sell it for a profit. The theory behind issuing stock options is that it aligns the interests of managers and shareholders and gives employees added incentive to help their company succeed. Broad-based employee stock options, especially in the technology sector, have led to economic growth, created great wealth for a large number of employees, and have been a driving force behind the success of many new ventures.

In any discussion of the accounting treatment of stock options it is important to note that the SEC has always had the ultimate authority to determine accounting standards for public companies under the securities laws. Prior to the enactment of the Sarbanes-Oxley Act, the SEC used its interpretive authority under section 13(b) of the Securities Exchange Act of 1934 to "define technical, trade, accounting and other terms * * * consistently with the provision and purposes of" that Act. Since 1973, the SEC on its own authority deferred to the Financial Accounting Standards Board (FASB) for purposes of defining what is "generally accepted" for accounting purposes. The FASB is an independent, private-sector organization with no Federal charter for its activities.

Enactment of the Sarbanes-Oxley Act in the 107th Congress added section 19(b) of the Securities Act of 1933 (1933 Act) which specifically authorized the SEC to recognize any accounting principles as "generally accepted" which were established by a standards setting organization meeting the description of the FASB. However, the SEC always retained the statutory authority to establish its own definition of "generally accepted," either generally,

or with respect to particular standards, a principle reiterated twice in the Sarbanes-Oxley Act, both in section 3(c) and 108(c).

FASB's current accounting standard for employee stock options recognized by the SEC provides that companies may either recognize the value of employee stock options as an expense or release relevant and detailed disclosure about those options in footnotes to company financial statements. The footnotes show how treating options as an expense would affect the company's profits.

On March 31, 2004, FASB proposed a rule that would require every company to count the value of all outstanding stock options that have not yet vested as an expense over the period they vest—a period that typically extends 3 to 5 years. Therefore, even if a company chose to stop issuing options altogether, it would still have to report expenses from options issued in earlier years, as they vest. The proposed rule would charge against earnings the estimated value of the options when they are issued, regardless of their value when they are exercised or if they are not exercised at all.

Broad-based employee stock option plans are a valuable tool used to attract talent to new ventures. It is widely believed that a rule requiring mandatory expensing of stock options will stifle their issuance, reduce company profits, and derail economic growth and innovation. Because stock options give employees a stake in their company and the potential to share in wealth creation, the disappearance of stock options will inhibit a company's ability to attract and retain skilled employees. If the currently proposed rule takes effect, many companies have stated that they will stop issuing options to their rank-and-file employees. In fact, this is exactly what some European-based companies have done following the issuance of the international rule requiring mandatory expensing of stock options. For example, after the rule was adopted in February, DaimlerChrysler AG and Deutsche Telekom announced that they will no longer issue stock options. In the United States, in anticipation of a rule requiring mandatory expensing of stock options, many companies such as Microsoft have stopped issuing stock options.

The accuracy of treating stock options as an expense is a matter of some debate among accounting experts. Moreover, the Committee received repeated testimony stating that there is no reliable or accurate formula to properly value those stock options. Under the proposed FASB rule, public companies would be required to estimate the cost of the options they award using either the Black-Scholes or binomial valuation models to calculate their value.

The use of either of these models for purposes of valuing employee stock options has been widely criticized. Both models rely on unpredictable and unreliable assumptions about interest rates and stock volatility in computing the values. In fact, the differences between the two models are sometimes large enough to make comparisons between companies difficult. Senator John Ensign, who chairs the Senate Republican High Tech Task Force, has said:

> The absence of an established, reliable method for measuring the value of stock options will result in confusion, uncertainty, and conflict. Trial lawyers will get rich as companies are forced to pick from flawed valuation models, and share prices plummet.

SEC Commissioner Paul Atkins is also concerned about mandatory expensing and has said efforts to require options to be treated as an expense could fail to give shareholders a clearer picture of a company's financial health and could do more harm than good. Stock option expensing will result in many companies reporting lower profits than they showed before they had to show stock options as an expense—even though the companies may have experienced virtually no substantive change in their operations. For instance, 2003 earnings of companies in the S&P 500 would have been 8 percent lower had companies been forced to treat options as an expense. It has been estimated that the operating earnings of the 100 largest companies traded on the Nasdaq stock market would have been 44 percent lower in 2003.

Finally, start-up companies would be severely harmed by mandatory expensing because it would make it more difficult for these companies to raise capital. H.R. 3574 addresses this concern by mandating the completion of the economic impact study before the Commission may recognize an accounting principle requiring the expensing of employee stock options. Some experts have opined that mandatory expensing for stock options would eventually push high-tech start-up companies to other countries, such as China and India, which do not require stock option expensing. This argument is bolstered by the fact that the Chinese government has incorporated stock options into its 5-year economic plan to boost its technology industry.

Venture-capital-backed companies have driven the global competitiveness of the United States by creating jobs, generating revenue, and fostering innovation. United States companies originally funded with venture capital now represent 11 percent of annual GDP and employ over 12 million Americans. A study published in 2000 comparing the productivity of public companies that offer broad-based stock option plans versus those that do not found that average productivity of the former grew 6 percent faster.

Critics of employee stock option plans have argued that those plans served as a motivating factor behind recent executive corruption scandals at public companies where, they argue, financial statements were falsified in order to enrich the top executives. H.R. 3574 addresses these concerns by requiring that public companies report as an expense on their income statement all options granted to the chief executive officer and the next 4 highest compensated employees. Accordingly, H.R. 3574 would be the first legislative mandate to require expensing of any kind for employee stock options. The bill exempts small businesses (defined as companies with annual revenues and aggregate outstanding stock of less than $25 million) from this requirement. It also provides an exemption from this requirement for companies for 3 years following their initial public offering.

In addition, H.R. 3574 requires the Commission to issue a rule mandating that public companies include more detailed information on stock option and stock purchase plans in their public periodic reports. This information will include, among other things, plain English descriptions of the dilutive effect of stock options, the impact of that dilutive effect on earnings per share, and the number of outstanding stock options.

H.R. 3574 prohibits the SEC from recognizing an accounting principle requiring that employee stock options be reported as an expense until the following conditions are met: (1) an economic impact study is completed, and (2) the accounting principle contains a "truing-up" mechanism.

With respect to the study, the Departments of Commerce and Labor are required to produce a joint study within one year on the economic impact of the mandatory expensing of stock options, focusing on the use of broad-based plans and their role in recruiting new employees, stimulating research and innovation, and fostering economic growth and international competitiveness. The Committee expects that the Commission will review this study and consider its results prior to recognizing as "generally accepted" any accounting standard relating to the expensing of employee stock options, and expects that the Commission will not recognize as "generally accepted" such an accounting principle if the study demonstrates that such principle would have a significant negative economic impact,

With regard to the "truing-up" requirement, the bill requires, that in order for the Commission to recognize as "generally accepted" an accounting principle relating to the expensing of employee stock options, that principle must provide that when a stock option is exercised, the option's previously reported expense must be recomputed as of the date of exercise, and any amount that differs from the amount previously reported should appear in the company's financial statement for the year in which the option is exercised as a reduction or increase, as appropriate, of the total option expense reported. In the event that an option is forfeited or expires unexercised, H.R. 3574 requires the option to appear as a reduction of the total expense reported during the same fiscal year. H.R. 3574 includes a savings clause to clarify that nothing in the bill limits the authority of an accounting standards setting body whose principles are recognized by the SEC to set accounting standards.

HEARINGS

The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a hearing on H.R. 3574, the Stock Option Accounting Reform Act. The following witnesses testified: Ms. Karen Kerrigan, Chairman, Small Business Survival Committee; Mr. Mark G. Heesen, President, National Venture Capital Association; Mr. Reginald Reed, Manager, Software Development, Cisco Systems; Professor Robert Merton, Harvard Business School; and Mr. Arthur W. Coviello, President and Chief Executive Officer, RSA Security.

COMMITTEE CONSIDERATION

The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises met in open session on May 12, 2004, and approved H.R. 3574 for full Committee consideration, as amended, by a voice vote.

The Committee on Financial Services met in open session on June 3 and 15, 2004, and ordered H.R. 3574 favorably reported to the House, with an amendment, by a record vote of 45 yeas and 13 nays (Record vote no. FC–21).

COMMITTEE VOTES

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. A motion by Mr. Oxley to favorably report the bill to the House with an amendment was agreed to by a record vote of 45 yeas and 13 nays (Record vote no. FC–21). The names of Members voting for and against follow.

Record vote no. FC-21

Representative	Aye	Nay	Present	Representative	Aye	Nay	Present
Mr. Oxley	X			Mr. Frank (MA)		X	
Mr. Leach				Mr. Kanjorski		X	
Mr. Bereuter				Ms. Waters		X	
Mr. Baker	X			Mr. Sanders		X	
Mr. Bachus	X			Mrs. Maloney		X	
Mr. Castle		X		Mr. Gutierrez		X	
Mr. King				Ms. Velázquez	X		
Mr. Royce	X			Mr. Watt		X	
Mr. Lucas (OK)				Mr. Ackerman	X		
Mr. Ney	X			Ms. Hooley (OR)	X		
Mrs. Kelly				Ms. Carson (IN)			
Mr. Paul	X			Mr. Sherman		X	
Mr. Gillmor		X		Mr. Meeks (NY)	X		
Mr. Ryun (KS)	X			Ms. Lee		X	
Mr. LaTourette	X			Mr. Inslee	X		
Mr. Manzullo	X			Mr. Moore	X		
Mr. Jones (NC)	X			Mr. Capuano	X		
Mr. Ose				Mr. Ford		X	
Mrs. Biggert				Mr. Hinojosa	X		
Mr. Green (WI)	X			Mr. Lucas (KY)	X		
Mr. Toomey	X			Mr. Crowley	X		
Mr. Shays				Mr. Clay	X		
Mr. Shadegg				Mr. Israel	X		
Mr. Fossella	X			Mr. Ross	X		
Mr. Gary G. Miller (CA)	X			Mrs. McCarthy (NY)	X		
Ms. Hart	X			Mr. Baca	X		
Mrs. Capito	X			Mr. Matheson	X		
Mr. Tiberi	X			Mr. Lynch	X		
Mr. Kennedy (MN)	X			Mr. Miller (NC)	X		
Mr. Feeney	X			Mr. Emanuel		X	
Mr. Hensarling	X			Mr. Scott (GA)	X		
Mr. Garrett (NJ)	X			Mr. Davis (AL)	X		
Mr. Murphy	X			Mr. Bell			
Ms. Ginny Brown-Waite (FL)							
Mr. Barrett (SC)	X						
Ms. Harris	X						
Mr. Renzi	X						

*Mr. Sanders is an independent, but caucuses with the Democratic Caucus.

The following amendments were considered by record votes. The names of Members voting for and against follow.

An amendment to the amendment in the nature of a substitute by Mr. Sherman, No. 1a, eliminating the zero volatility assumption, was NOT AGREED TO by a record vote of 14 yeas and 43 nays (Record vote no. FC–18).

Record vote no. FC-18

Representative	Aye	Nay	Present	Representative	Aye	Nay	Present
Mr. Oxley		X		Mr. Frank (MA)	X		
Mr. Leach				Mr. Kanjorski	X		
Mr. Bereuter				Ms. Waters	X		
Mr. Baker		X		Mr. Sanders	X		
Mr. Bachus		X		Mrs. Maloney	X		
Mr. Castle	X			Mr. Gutierrez	X		
Mr. King				Ms. Velázquez		X	
Mr. Royce		X		Mr. Watt	X		
Mr. Lucas (OK)				Mr. Ackerman	X		
Mr. Ney		X		Ms. Hooley (OR)		X	
Mrs. Kelly				Ms. Carson (IN)			
Mr. Paul		X		Mr. Sherman	X		
Mr. Gillmor	X			Mr. Meeks (NY)			
Mr. Ryun (KS)		X		Ms. Lee	X		
Mr. LaTourette		X		Mr. Inslee		X	
Mr. Manzullo		X		Mr. Moore		X	
Mr. Jones (NC)		X		Mr. Capuano		X	
Mr. Ose				Mr. Ford		X	
Mrs. Biggert		X		Mr. Hinojosa		X	
Mr. Green (WI)		X		Mr. Lucas (KY)		X	
Mr. Toomey		X		Mr. Crowley			
Mr. Shays				Mr. Clay	X		
Mr. Shadegg				Mr. Israel		X	
Mr. Fossella		X		Mr. Ross		X	
Mr. Gary G. Miller (CA)		X		Mrs. McCarthy (NY)		X	
Ms. Hart		X		Mr. Baca		X	
Mrs. Capito		X		Mr. Matheson		X	
Mr. Tiberi		X		Mr. Lynch		X	
Mr. Kennedy (MN)		X		Mr. Miller (NC)		X	
Mr. Feeney		X		Mr. Emanuel	X		
Mr. Hensarling		X		Mr. Scott (GA)		X	
Mr. Garrett (NJ)		X		Mr. Davis (AL)		X	
Mr. Murphy		X		Mr. Bell			
Ms. Ginny Brown-Waite (FL)							
Mr. Barrett (SC)		X					
Ms. Harris		X					
Mr. Renzi		X					

*Mr. Sanders is an independent, but caucases with the Democratic Caucus.

An amendment to the amendment in the nature of a substitute by Ms. Maloney, No. 1e, confirming SEC authority, was NOT AGREED TO by a record vote of 14 yeas and 45 nays (Record vote no. FC–19).

Record vote no. FC-19

Representative	Aye	Nay	Present	Representative	Aye	Nay	Present
Mr. Oxley		X		Mr. Frank (MA)	X		
Mr. Leach				Mr. Kanjorski	X		
Mr. Bereuter				Ms. Waters	X		
Mr. Baker		X		Mr. Sanders	X		
Mr. Bachus		X		Mrs. Maloney	X		
Mr. Castle	X			Mr. Gutierrez	X		
Mr. King				Ms. Velázquez		X	
Mr. Royce		X		Mr. Watt	X		
Mr. Lucas (OK)				Mr. Ackerman	X		
Mr. Ney		X		Ms. Hooley (OR)		X	
Mrs. Kelly				Ms. Carson (IN)			
Mr. Paul		X		Mr. Sherman	X		
Mr. Gillmor	X			Mr. Meeks (NY)		X	
Mr. Ryun (KS)		X		Ms. Lee	X		
Mr. LaTourette		X		Mr. Inslee		X	
Mr. Manzullo		X		Mr. Moore		X	
Mr. Jones (NC)		X		Mr. Capuano		X	
Mr. Ose				Mr. Ford		X	
Mrs. Biggert		X		Mr. Hinojosa		X	
Mr. Green (WI)		X		Mr. Lucas (KY)		X	
Mr. Toomey		X		Mr. Crowley		X	
Mr. Shays				Mr. Clay		X	
Mr. Shadegg				Mr. Israel		X	
Mr. Fossella		X		Mr. Ross		X	
Mr. Gary G. Miller (CA)		X		Mrs. McCarthy (NY)		X	
Ms. Hart		X		Mr. Baca		X	
Mrs. Capito		X		Mr. Matheson		X	
Mr. Tiberi		X		Mr. Lynch		X	
Mr. Kennedy (MN)		X		Mr. Miller (NC)	X		
Mr. Feeney		X		Mr. Emanuel	X		
Mr. Hensarling		X		Mr. Scott (GA)		X	
Mr. Garrett (NJ)		X		Mr. Davis (AL)		X	
Mr. Murphy		X		Mr. Ball			
Ms. Ginny Brown-Waite (FL)							
Mr. Barrett (SC)		X					
Ms. Harris		X					
Mr. Renzi		X					

*Mr. Sanders is an independent, but caucuses with the Democratic Caucus.

An amendment to the amendment in the nature of a substitute by Mr. Sherman, No. 1f, applying the FASB standard for options exceeding $100,000 per employee, was NOT AGREED TO by a record vote of 12 yeas and 47 nays (Record vote no. FC–20).

Record vote no. FC-20

Representative	Aye	Nay	Present	Representative	Aye	Nay	Present
Mr. Oxley		X		Mr. Frank (MA)	X		
Mr. Leach				Mr. Kanjorski	X		
Mr. Bereuter				Ms. Waters		X	
Mr. Baker		X		Mr. Sanders	X		
Mr. Bachus		X		Mrs. Maloney	X		
Mr. Castle		X		Mr. Gutierrez	X		
Mr. King				Ms. Velázquez		X	
Mr. Royce		X		Mr. Watt	X		
Mr. Lucas (OK)				Mr. Ackerman	X		
Mr. Ney		X		Ms. Hooley (OR)		X	
Mrs. Kelly				Ms. Carson (IN)			
Mr. Paul		X		Mr. Sherman	X		
Mr. Gillmor		X		Mr. Meeks (NY)		X	
Mr. Ryun (KS)		X		Ms. Lee	X		
Mr. LaTourette		X		Mr. Inslee		X	
Mr. Manzullo		X		Mr. Moore		X	
Mr. Jones (NC)		X		Mr. Capuano		X	
Mr. Ose				Mr. Ford	X		
Mrs. Biggert		X		Mr. Hinojosa		X	
Mr. Green (WI)		X		Mr. Lucas (KY)		X	
Mr. Toomey		X		Mr. Crowley		X	
Mr. Shays				Mr. Clay	X		
Mr. Shadegg				Mr. Israel		X	
Mr. Fossella		X		Mr. Ross		X	
Mr. Gary G. Miller (CA)		X		Mrs. McCarthy (NY)		X	
Ms. Hart		X		Mr. Baca		X	
Mrs. Capito		X		Mr. Matheson		X	
Mr. Tiberi		X		Mr. Lynch		X	
Mr. Kennedy (MN)		X		Mr. Miller (NC)		X	
Mr. Feeney		X		Mr. Emanuel	X		
Mr. Hensarling		X		Mr. Scott (GA)		X	
Mr. Garrett (NJ)		X		Mr. Davis (AL)		X	
Mr. Murphy		X		Mr. Bell			
Ms. Ginny Brown-Waite (FL)							
Mr. Barrett (SC)		X					
Ms. Harris		X					
Mr. Renzi		X					

*Mr. Sanders is an independent, but caucuses with the Democratic Caucus.

The following amendments were also considered:

An amendment in the nature of a substitute by Mr. Oxley, No. 1, making various substantive and technical changes to the bill, was agreed to by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Sherman, No. 1b, providing a 1-year deadline for an economic impact study was agreed to by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Baker, No. 1c, regarding preservation of authority, was agreed to by a voice vote.

An amendment to the amendment in the nature of a substitute by Mr. Sherman, No. 1d, making the provisions of the bill effective until SEC adoption of rule providing for recognition of certain development expenditures as intangible assets, was withdrawn.

A substitute amendment in the nature of a substitute by Mr. Kanjorski, No. 2, replacing the provisions of the bill with the provisions of the "Accounting Standards Integrity Act," was not agreed to by a voice vote. The request for a recorded vote was withdrawn.

COMMITTEE OVERSIGHT FINDINGS

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the Committee held a hearing and made findings that are reflected in this report.

PERFORMANCE GOALS AND OBJECTIVES

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee establishes the following performance related goals and objectives for this legislation:

The Securities and Exchange Commission will (1) enforce the provisions of this legislation requiring that every issuer of a security registered pursuant to section 12 of the 1934 Act show as an expense in its annual report the fair value of all options to purchase the stock of the issuer granted after December 31, 2004, to a "named executive officer" of the issuer and (2) not recognize as "generally accepted" any accounting principle relating to the expensing of stock options unless it complies with certain requirements for "truing-up" the expense attributable to an option and an economic impact study must has been completed by the Departments of Commerce and Labor.

NEW BUDGET AUTHORITY, ENTITLEMENT AUTHORITY, AND TAX EXPENDITURES

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee finds that this legislation would result in no new budget authority, entitlement authority, or tax expenditures or revenues.

COMMITTEE COST ESTIMATE

The Committee adopts as its own the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

CONGRESSIONAL BUDGET OFFICE ESTIMATE

Pursuant to clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the following is the cost estimate provided by the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, June 25, 2004.

Hon. MICHAEL G. OXLEY,
Chairman, Committee on Financial Services,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 3574, the Stock Option Accounting Reform Act.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contacts are Melissa E. Zimmer-

man (for federal costs), and Paige Piper/Bach (for the private-sector impact).

Sincerely,

DOUGLAS HOLTZ-EAKIN,
Director.

Enclosure.

H.R. 3574—Stock Option Accounting Reform Act

Summary: H.R. 3574 would require publicly traded companies to include the value of a certain portion of stock options as an expense in the firm's annual financial report. (This practice is known as "expensing stock options.") The bill's requirement would apply to the stock options granted to a company's chief executive officer and the four highest-paid executive officers. The bill would exclude certain small companies from this requirement.

Under the bill, the Securities and Exchange Commission (SEC) would create regulations for expensing stock options, and the Departments of Commerce and Labor would study the economic impact of implementing expensing of stock options for all of a company's employees. CBO estimates that implementing H.R. 3574 would not have a significant effect on spending subject to appropriation and would not affect direct spending or revenues.

H.R. 3574 contains no intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would impose no significant costs on state, local or tribal governments.

H.R. 3574 would impose private-sector mandates as defined in UMRA on certain companies. Based on information from industry and government sources, CBO expects that the aggregate direct costs of complying with those mandates would fall below the annual threshold established by UMRA for private-sector mandates ($120 million in 2004, adjusted annually for inflation).

Impact on the private sector

Expensing of stock options held by executive officers

Section 2 would impose a private-sector mandate on certain companies that grant some compensation through stock options. The provision would require such companies to recognize as an expense in their annual report to the SEC the fair value (as defined in the bill) of certain options to purchase stock granted to the chief executive officer and the four most highly compensated executives of the company. To recognize an expense means it is included in the calculation of reported net income. Current accounting standards require that firms recognize as an expense or disclose the fair value of all stock options they grant. Consequently, CBO expects that complying with this mandate would result in minimal additional cost.

Additional disclosures in periodic reports

Section 4 would require the SEC to implement rules that would require certain companies to provide more detailed information specified in the bill regarding employee stock option plans in the periodic reports filed with the SEC. According to industry and government sources, most of this information is already required by the SEC in the periodic reports provided by firms. Therefore, CBO

expects that the direct cost to comply with this mandate would be minimal.

Standards for expensing stock options

Section 3 would prohibit the SEC from recognizing as "generally accepted" any accounting principle relating to the expensing of stock options unless it complies with certain requirements specified in the bill and an economic impact study required in the bill has been completed. If the SEC adopts the requirements in the bill for expensing stock options as generally accepted accounting principles, those requirements would be new private-sector mandates on certain companies that grant stock options. Such requirements are similar to current rules that companies follow regarding the expensing of stock options for income-tax purposes. Consequently, CBO expects that complying with such requirements would result in minimal additional cost to firms.

Estimate prepared by: Federal Costs: Melissa Zimmerman; Impact on State, Local, and Tribal Governments: Sarah Puro; and Impact on the Private Sector: Paige Piper/Bach.

Estimate approved by: Peter H. Fontaine, Deputy Assistant Director for Budget Analysis.

FEDERAL MANDATES STATEMENT

The Committee adopts as its own the estimate of Federal mandates prepared by the Director of the Congressional Budget Office pursuant to section 423 of the Unfunded Mandates Reform Act.

ADVISORY COMMITTEE STATEMENT

No advisory committees within the meaning of section 5(b) of the Federal Advisory Committee Act were created by this legislation.

CONSTITUTIONAL AUTHORITY STATEMENT

Pursuant to clause 3(d)(1) of rule XIII of the Rules of the House of Representatives, the Committee finds that the Constitutional Authority of Congress to enact this legislation is provided by Article 1, section 8, clause 1 (relating to the general welfare of the United States) and clause 3 (relating to the power to regulate interstate commerce).

APPLICABILITY TO LEGISLATIVE BRANCH

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of section 102(b)(3) of the Congressional Accountability Act.

SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

Section 1. Short title

This section establishes the short title of the bill, the "Stock Option Accounting Reform Act."

Section 2. Mandatory expensing of stock options held by highly compensated officers

Section 2 amends section 13 of the Securities Exchange Act of 1934 (the 1934 Act) to add a new section 13(m), requiring that every issuer of a security registered pursuant to section 12 of the 1934 Act show as an expense in its annual report the fair value of all options to purchase the stock of the issuer granted after December 31, 2004, to a "named executive officer" of the issuer.

"Named executive officer" is defined as all individuals serving as the issuer's chief executive officer during the most recent fiscal year, regardless of compensation level, and the 4 most highly compensated executive officers, other than the chief executive officer.

The section defines the "fair value" of an option to purchase the issuer's stock as the value that would be agreed upon by a willing buyer and seller of the option, taking into account all of the characteristics and restrictions imposed upon the option. In addition, the section provides that, to the extent that an option pricing model, such as the Black-Scholes method or a binomial model, is used to determine the fair value of an option, the assumed volatility of the underlying stock will be zero.

The section includes two exemptions from the expensing requirement for small business issuers and new issuers. In order to qualify for the small business issuer exemption, the issuer must (a) have annual revenues of less than $25,000,000; (b) be organized under the laws of the United States, Canada, or Mexico; (c) not be an investment company; (d) have outstanding voting and non-voting common equity securities held by non-affiliated parties amounting to less than $25,000,000; and (e) in the case of an issuer that meets the aforementioned criteria and is a majority-owned subsidiary, a subsidiary of a parent that also meets the aforementioned criteria.

The exemption for new issuers provides that the expensing requirements of this provision do not apply in the first 3 years after an issuer's initial public offering and only applies to options granted after the 3–year grace period.

Section 3. Prohibition on expensing and economic impact study

Section 3 amends section 19(b) of the 1933 Act by adding a new paragraph (3), prohibiting the Securities and Exchange Commission from recognizing as "generally accepted" any accounting principle relating to the expensing of stock options unless: (a) it complies with certain requirements for "truing-up" the expense attributable to an option; and (b) an economic impact study has been completed.

To satisfy the "truing-up" requirement of this section, a standard must meet 3 conditions:

First, the standard must provide that if an option to purchase the issuer's stock is exercised and that option is subject to the requirements of new section 13(m) of the 1934 Act, then (a) any expense that had been reported with respect to the option must be recomputed as of the date of exercise and will be equal to the difference between the price of the underlying stock and the exercise price; and (b) to the extent the recomputed amount differs from the amount previously reported with respect to that option, the difference must be reported in the fiscal year in which the option is

exercised as a reduction or increase, as the case may be, of the total expense reported during that fiscal year.

Second, the standard must provide that if an option to purchase an issuer's stock is forfeited or expires unexercised and that option is subject to the requirements of new section 13(m), then any expense that had been reported with respect to that option must be reported in the same fiscal year as a reduction of the total expense reported.

Finally, to the extent that any reduction required under the two previous paragraphs exceeds total option expenses for any fiscal year, then that excess must be reported as income with respect to options to purchase the stock of the issuer.

To satisfy the economic impact study requirement of the section, the Secretary of Commerce and the Secretary of Labor, within 1 year of the date of enactment of this legislation, must conduct and complete a joint study on the economic impact of the mandatory expensing of all employee stock options. The section requires that this study specifically address the impact of mandatory expensing of employee stock options on (1) the use of broad-based stock option plans in expanding employee corporate ownership to workers at a wide range of income levels, with particular focus upon non-executive employees; (2) the role of those plans in the recruitment and retention of skilled workers; (3) the role of those plans in stimulating research and innovation; (4) the effect of those plans in stimulating the economic growth of the United States; and (5) the role of those plans in strengthening the international competitiveness of businesses organized under the laws of the United States.

Section 4. Improved employee stock option transparency and reporting disclosures

Section 4 requires enhanced disclosure about stock option and similar plans. Specifically, it requires that, no later than 180 days after the date of enactment of this legislation, the Commission must, by rule, require that each issuer filing a periodic report under section 13(a) or 15(d) of the 1934 Act include in that report more detailed information regarding stock option plans, stock purchase plans, and other arrangements involving an employee acquisition of an equity interest in the company. This information must include six components: (1) a "plain English" discussion of the dilutive effect of stock option plans, including tables or graphic illustrations of such dilutive effects; (2) expanded disclosure of the dilutive effect of employee stock options on the issuer's earnings per share; (3) prominent placement and increased comparability and uniformity of all stock option related information; (4) the number of outstanding stock options; (5) the weighted average exercise prices of all outstanding stock options; and (6) the estimated number of stock options outstanding that will vest in each year.

The section also defines the terms "commission," "issuer," and "equity interest."

Section 5. Preservation of authority

This section clarifies that nothing in this bill limits the authority over the setting of accounting principles by an accounting standards setting body whose principles are recognized by the SEC.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (new matter is printed in italic and existing law in which no change is proposed is shown in roman):

SECTION 13 OF THE SECURITIES EXCHANGE ACT OF 1934

TITLE I—REGULATION OF SECURITIES EXCHANGES

PERIODICAL AND OTHER REPORTS

SEC. 13. (a) * * *

* * * * * * *

(m) MANDATORY EXPENSING OF STOCK OPTIONS.—

(1) NAMED EXECUTIVE OFFICER.—As used in this subsection, the term "named executive officer" means—

(A) all individuals serving as the chief executive officer of an issuer, or acting in a similar capacity, during the most recent fiscal year, regardless of compensation level; and

(B) the 4 most highly compensated executive officers, other than an individual identified under subparagraph (A), that were serving as executive officers of an issuer at the end of the most recent fiscal year.

(2) IN GENERAL.—Subject to paragraph (4), every issuer of a security registered pursuant to section 12 shall show as an expense in the annual report of such issuer filed under subsection (a)(2), the fair value of all options to purchase the stock of the issuer granted after December 31, 2004, to a named executive officer of the issuer.

(3) FAIR VALUE.—

(A) IN GENERAL.—The fair value of an option to purchase the stock of the issuer that is subject to paragraph (2) shall—

(i) be equal to the value that would be agreed upon by a willing buyer and seller of such option, who are not under any compulsion to buy or sell such option; and

(ii) take into account all of the characteristics and restrictions imposed upon the option.

(B) PRICING MODEL.—To the extent that an option pricing model, such as the Black-Scholes method or a binomial model, is used to determine the fair value of an option, the assumed volatility of the underlying stock shall be zero.

(4) EXEMPTIONS.—

(A) SMALL BUSINESS ISSUERS.—This subsection shall not apply to an issuer, if—

(i) the issuer has annual revenues of less than $25,000,000;

(ii) the issuer is organized under the laws of the United States, Canada, or Mexico;

(iii) the issuer is not an investment company (as such term is defined under section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3));

(iv) the aggregate value of the outstanding voting and non-voting common equity securities of the issuer held by non-affiliated parties is less than $25,000,000; and

(v) in the case of an issuer that meets the criteria in clauses (i) through (iv) and is a majority-owned subsidiary, the parent of the issuer meets the requirements of this paragraph.

(B) DELAYED EFFECTIVENESS.—The requirements of this subsection shall not apply to an issuer before the end of the 3-year period beginning on the date of the completion of the initial public offering of the securities of the issuer, and shall only apply to an option to purchase the stock of an issuer granted after such date.

* * * * * * *

SECTION 19 OF THE SECURITIES ACT OF 1933

SPECIAL POWERS OF COMMISSION

SEC. 19. (a) * * *

(b) RECOGNITION OF ACCOUNTING STANDARDS.—

(1) * * *

* * * * * * *

(3) PROHIBITION ON EXPENSING STANDARDS.—

(A) IN GENERAL.—The Commission shall not recognize as "generally accepted" any accounting principle relating to the expensing of stock options unless—

(i) it complies with the requirements of subparagraph (B); and

(ii) the economic impact study required under section 3(b) of the Stock Option Accounting Reform Act has been completed.

(B) REQUIREMENTS.—A standard referred to in subparagraph (A) shall require that—

(i) if an option to purchase the stock of an issuer that is subject to the requirements of section 13(m) of the Securities Exchange Act of 1934 is exercised—

(I) any expense that had been reported under that section 13(m) with respect to such option shall be recomputed as of the date of exercise and shall be equal to the difference between the price of the underlying stock and the exercise price; and

(II) to the extent the recomputed amount differs from the amount previously reported under section 13(m) with respect to such option, the difference shall be reported in the fiscal year in which the option is exercised as a reduction or increase, as the case may be, of the total expense required to be reported under that section 13(m) during that fiscal year;

(ii) if an option to purchase the stock of an issuer that is subject to the requirements of section 13(m) of the Securities Exchange Act of 1934 is forfeited or expires unexercised, any expense that had been reported under that section 13(m) with respect to such option shall be reported in the fiscal year in which the option expires or is forfeited as a reduction of the total expense required to be reported under that section 13(m) during that fiscal year; and

(iii) to the extent that any reduction required under clause (i) or (ii) exceeds total option expenses for any fiscal year, such excess shall be reported as income with respect to options to purchase the stock of the issuer.

* * * * * * *

○