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Google's Transferable Stock Options
The Option Grant Date Under 123(R)

A Word from the Publisher

We take a close look at the program Google and Morgan Stanley have put together for "Googlers," who are now able to sell instead of exercise their employee stock options (pgs 1-7). It is readily apparent from a review of Google's SEC filings that a great deal of thought and preparation have gone into the program.

We then examine the determination of the option grant date under FAS 123(R) (pgs 7-11). We conclude with a look at a precursor to the "say on pay" trend that seems to be coming down the track (pg 11).

TSO Panel at NASPP Conference

We already are looking forward to the TSO presentation by Google and its legal team and others, at the NASPP Annual Conference scheduled for October 9-12 in San Francisco. For more information, go to Naspp.com.

And don't forget to act on the Early Bird Rate for the "Member Appreciation Package" for the "2nd Annual Proxy Disclosure" and "4th Annual Executive Compensation" Conferences. The Early Bird expires June 30th for these Conferences to be held in San Franscisco and via Nationwide Live Video Webcast in mid-October. For more information, go to TheCorporateCounsel.net.

—Eds.

Google's TSO Program

Add one more to Google's well-publicized employee perks, *e.g.,* free cafeteria, free child care and onsite laundry facilities, flexible work hours, etc.

In December, Google announced a program, developed with Morgan Stanley, enabling employees (excluding executives and directors) to sell their vested stock options to financial institutions via a continuous, real-time, online auction (Morgan Stanley is actually seeking a patent on the auction system); Google's transferable stock options can be sold only via the auction. The program covers extant options as well as future grants, but excludes Google's pre-IPO grants and any options assumed in a merger, etc. Employees still have the choice of exercising their options in the traditional manner, but now can increase their gain by instead selling their options.

The auction started up on April 23 (with Google's "window" period following announcement of its Q.1 results on Friday, April 20). [Window periods generally start a business day or two after the earnings release. With today's free, instant EDGAR availability (and required 8-K filing of earnings releases), some companies might consider opening their window immediately, but there would still be a perception problem (*i.e.,* that insiders with prior knowledge are advantaged until the announcement is fully disseminated).]

Incremental "Exercise" Proceeds

Because the option sale price includes both the intrinsic value (*i.e.,* spread) of an option at the sale date (which, of course, is what employees typically realize on option exercises) and value for the remaining time that the option can be exercised

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(up to a maximum of two years—see below), employees should almost always be able to realize more by selling their option than by exercising and selling the stock. In fact, the auction has a built-in "reserve" feature that accepts only bids that exceed the intrinsic value (for underwater options, however, that would theoretically permit a bid of zero). Google says it will summarize the results of the program quarterly beginning with its Q.2 Form 10-Q; hopefully, the summary will show the amounts the program is yielding in excess of the option spread.

Google acknowledges in its stock plan prospectus (since Google is now using SEC Form S-3, not S-8—see pg 6, its offering materials are actually filed with the SEC) that grant date values derived by Black-Scholes for accounting purposes typically exceed the "true value" of options to the employee. (See, generally, the Risk Factors relating to the TSO program, at pgs 3-5 of Google's stock plan prospectus.) The TSO program is designed to reduce that gap by increasing the amount employees can realize from their options (even though it is unlikely that TSOs can be sold for the full Black-Scholes value, calculated at the time of sale).

A perception problem that companies may need to address is employees' expectation that the sale price obtainable in the auction may equal, or even exceed, Black-Scholes. [While Black-Scholes values normally aren't communicated to employees, it may be possible to extrapolate the grant date value of individual grants from the FAS 123(R) footnote in the financial statements. Some companies actually include the Black-Scholes value when presenting option grants to employees, both to demonstrate value and to help explain how the number of shares was determined.] However, because options cannot be sold until vested, there normally will be a significant time gap between 123(R) valuation and sale price quotes for an option.

Online Auction

The auction is managed by Morgan Stanley, which also is a bidder for the options purchased. The other potential bidders are financial institutions and other institutional investors, chosen at Google's "sole discretion." Initially, there are three other bidders (Citigroup, Credit Suisse and UBS).

Buyers are not allowed to further sell or transfer their options, so no secondary market can exist for options sold in the program. Buyers typically will hedge their financial risk (*i.e.,* from buying and holding the options) via short sales of Google stock (effected immediately upon purchase of an option). There must be a minimum of two bidders for any bid to be conveyed, but there is no SEC requirement here for an open auction *a la* the Zions program featured in our March-April 2007 issue, in that Google's program is not intended to establish evidence of fair value for 123(R) purposes.

Each employee who enrolls in the TSO program can (i) access their own page on Google's internal online system that shows the current high bid offered for their vested options (bids are updated approximately every 30 seconds), as well as (ii) submit sale orders (either a "market" order, or a "limit" order specifying a minimum sale price). (Morgan Stanley has graciously allowed us to post specimen auction computer screens on Naspp.com.) Bidders must bid for all options in the program. Participating employees can still elect traditional option exercise at any time, and those who don't enroll upfront can do so later at any time.

Morgan Stanley expects to offer the TSO auction program to other companies down the road. And, of course, other investment banks may sponsor similar programs.

<u>Underwater Options.</u> Because the program encourages employees to focus on the overall value of their options, not just the intrinsic value/spread, even underwater options can now have a positive/retention effect. (Although Google mentions a potential opposite effect, *i.e.,* that options might be sold soon after going underwater, thereafter having no further retention, etc. effect.) Microsoft demonstrated, with its one-time transferable option program in 2003, specifically designed to facilitate sales of its underwater options (see our September-October 2003 issue at pg 1), that financial institutions are willing to buy underwater options. Ditto, Comcast in 2004.

<u>Terminated Employees Excluded.</u> Only current Google employees are entitled to participate in the program. After termination of employment (presumably, that means after termination of service, and not during the period between notice of termination and actual termination of service), optionees are limited to traditional option exercises (*e.g.,* cash and same-day sales). There may be a potential litigation concern here, in that an employee terminated by the company may feel deprived of incremental value.

Moreover, no option with less than six months until expiration can be sold in the program, even by current employees. Presumably, this is because the limited period eliminates virtually all of the time value associated with the option, making sale of the option not worth the administrative hassle (vs. exercise and sale of the shares).

Program Does Not Establish Fair Value for 123(R) Purposes; Google's 123(R) Values Will Actually Increase

Although several companies and institutions (*e.g.,* Cisco and Bear Stearns—see our September-October 2006 issue at pg 9) have proposed (but, none has yet received Staff blessing of) sale by the company to investors of various types of transferable options that could be used to establish 123(R) fair value for contemporaneously granted options, Google's TSO program is not designed for this purpose. Since employees will not be able to sell their options prior to vesting, any value established by a sale would be too late to be used for 123(R) valuation (in fact, the sold portion of any option would have been fully vested and expensed by then).

The sale price of a TSO (including the time value aspect) depends in large part on stock price changes and other factors occurring after the grant date, which are irrelevant to grant date valuation. Google will continue to value its options at grant using Black-Scholes. [We wonder whether, down the road, if TSO sales reflect prices considerably below the Black-Scholes value (at the time of sale), Google might attempt to use that input to reduce future grant date values. Google says that TSO sales ultimately could provide "observable market prices" relevant to 123(R) grant-date valuation. In that event, we think the regulators would have concerns with, *e.g.,* the openness of the auction program.]

<u>Transferability Lengthens the Expected Term to the Full Contractual Option Term, Increasing 123(R) Fair Value.</u> As our readers may recall, the traditional Black-Scholes model, used to value *traded* options, incorporates the *contractual* term of the option. For employee stock options, the Black-Scholes model has been modified to incorporate instead the *expected* term, *i.e.,* the length of time until the option is expected to be exercised. (See the July-August 1993 issue of *The Corporate Counsel* at pg 1.) This modification of Black-Scholes is in recognition of the fact that, because employee stock options traditionally are not transferable, employees are likely to exercise them before they reach full maturity.

Where options are transferable, however, this all goes out the window, in that there is less (or no) reason for the options to be exercised prior to maturity. [The only exceptions might be for options that are steeply in the money (the more in-the-money an option is, the less proportionately its time value), options that are close to expiring (since there is little time value), or options on dividend paying stocks, which Google is not (so the option holder can begin receiving the dividends).] Thus, in valuing its TSOs, Google would assume an expected term equal to the full contractual term of the option (ten years, unless Google shortens the term of TSOs).

This could significantly increase the 123(R) fair value of Google's option grants going forward. Thus, for its (non-transferable) grants in 2006, Google assumed a weighted average expected term of about four years, expected volatility of 34%, and an interest rate of 4.7%. At a stock price of about $500 per share, this results in a Black-Scholes value of about $170. If forced to assume a term of ten years, the Black-Scholes value would be about $270 (an increase in stock option compensation expense of almost 60%).

<u>*Conversion of TSOs Upon Sale to (Common Stock Purchase Warrants with) Maximum Term of Two Years.*</u> To mitigate this effect, the TSO program provides that the contractual term of any transferred TSO will upon transfer be reduced to a maximum of two years (if the option term remaining at the sale date is less than two years, the term upon transfer is shortened in six-month increments; *e.g.,* 23 months remaining becomes 18 months upon transfer); with Microsoft's 2003 option sales, the option term was shortened to three years post-transfer. Shortening the term post-transfer allows Google to assume upfront an expected term of six years instead of ten (the four years the employee is expected to wait before selling the option—presumably, employees are assumed to sell at the same time they previously would have exercised—plus the two-year post-transfer contractual term), resulting in a Black-Scholes value of about $210 (an increase of about 25% instead of 60%).

Moreover, upon sale, any remaining forfeiture provisions of the option are no longer applicable (Google says termination of employment is an example here, *i.e.,* the post-termination exercise period cutoff wouldn't apply; at some companies, a non-compete forfeiture provision would be another example of the type of provision that would no longer be applicable.) Ditto, any acceleration of expiration (*e.g.,* upon a change of control) would be inapplicable. And, anti-dilution provisions typical of traded call options go into effect.

123(R) Impact of Modification of Existing Employee Options. Google is not only including the transferability provision in all new grants to eligible employees, but is also providing transferability for all post-IPO grants held by eligible employees. Amending the extant options is a "modification" under 123(R). Under 123(R), as we have discussed, Google would compute the value of the options just before and just after the modification and recognize any resulting increase in value as incremental expense. Here, the increase in fair value will be the impact of the longer expected term (by two years), as discussed above.

Google discloses a current (*i.e.,* 2007 Q.2) 123(R) charge of $90 million for the modification of options that are already vested, and anticipated future charges of an additional $170 million over the remaining vesting periods. [Apparently, Google decided to amend all eligible options upfront, rather than take the administratively—and legally, see *Does Modification of Existing Options Involve A Tender Offer?*, pg 6—more complicated route of modifying only the options of employees enrolling in the program or those actually desiring to sell an option; waiting to modify until an employee decides to enroll/sell might well result in even higher charges down the road, *i.e.,* where the stock price has increased. Google may have concluded that, in any event, merely allowing employees to transfer their option *de facto* modifies all options that qualify to be sold.]

That Google has seen fit to incur $260 million of charges in order to apply the TSO program to extant options (rather than just to new grants going forward) may be a testament to the marketplace's willingness to separate out cashless stock option charges (especially, where nonrecurring); thus, the $90 million Q.2 charge would reduce Q.2 operating income by approximately 12% based on Q.1's income level. As our readers know, we applaud disclosure of stock compensation accounting effects (see the May-June 2005 issue of *The Corporate Counsel* at pg 10), whether in a proxy statement soliciting approval of a plan or a stock plan prospectus.

Income Tax Treatment

Sale of Option. The entire gain realized by an employee on the sale of a TSO (not just the market spread on the sale date) is compensation income to the employee, subject to W-2 reporting and withholding. For example, assume an employee holds a TSO to purchase 1,000 shares at an exercise price of $400 and that the current market price of the stock is $500. A traditional exercise would result in W-2 income of $100,000 (transferable options obviously are not eligible to be ISOs), with tax liability of $36,450 (setting aside state taxes and assuming the highest marginal rate of 35% for FIT and only the 1.45% portion of FICA/Medicare), with withholding due of $26,450 (25% of $100,000—see our November-December 2006 issue at pg 10—plus 1.45%).

With the new auction program, the option might instead be sold for, say, its then Black-Scholes value, approximately $166 per share, assuming the 34% volatility Google used for its 2006 grants and a remaining expected term of two years (which is what the bidding financial institution would use in valuing the option, since the option term will be truncated to two years upon transfer). The employee would receive and recognize $166,000 (instead of $100,000) of compensation income, resulting in an actual tax liability of just under $62,000 (and approximately $44,000 withholding).

We use the Black-Scholes value here for illustration purposes only. It is unlikely that a financial institution would actually be willing to pay full Black-Scholes (even though, as we have oft-discussed, the spread of an in-the-money option doesn't increase Black-Scholes value dollar-for-dollar, in that, as the spread/discount goes up the time value component goes down). The financial institutions participating in the auction are expected to develop their own pricing models; thus, the price they are willing to pay may be significantly less than Black-Scholes, as evidenced by the results of Zions' first ESOARS auction (see our March-April 2007 issue at pg 1) and the results of Microsoft's 2003 program. A hypothetical that Google uses in its offering materials is a sale price of $184 for an option with a spread of $143, an approximate 28% premium (the hypothetical doesn't provide enough information to extrapolate a Black-Scholes value). It will be interesting to see the actual results.

If, instead of selling the option, or exercising and selling the stock immediately, the employee were to exercise with cash and hold the stock for more than one year, the post-exercise appreciation would be subject to long-term capital gain rates. Say, the employee sells the stock then for $566, essentially realizing the additional $66 per share that s/he would have gotten by selling the option a year earlier. The tax liability on the additional $66,000 of profit is $9,900 (at the maximum 15% LTCG rate), resulting in a total tax liability (including the tax due at exercise) of $46,900 instead of $62,000. [For most, this cash exercise analysis is unlikely to be relevant, since few employees have the financial resources to engage in cash exercises (especially at Google's stock prices) or to bear the market risk of owning the stock for a year. Even where the employee has the resources, the potential tax advantage probably doesn't justify the level of risk involved and carrying costs for the exercise.]

The company's tax deduction in all scenarios equals the employee's W-2 amount; thus, the company's incremental tax savings (from TSO sales vs. traditional exercises) mitigates to a modest extent the above mentioned incremental accounting cost incurred for TSOs (see our January-February 2005 issue at pg 1). Following sale of an option in the auction, there are no further tax consequences to the employee or the company.

Grant and Vesting of TSOs; Modification of Outstanding Options. Apparently, Google has obtained comfort (a Private Letter Ruling?) from the IRS that neither the grant nor vesting of transferable stock options constitutes a compensable "transfer" to the employee of "property" with a "readily ascertainable fair market value" within the meaning of IRC §83 and Regs. Under PLR 9616035, there is no taxation on grant of a transferable employee stock option. (See our May-June 1996 issue at pg 6.) Similarly, per Microsoft's PLR 200414007, the amendment of outstanding options (even vested tranches) to add transferability does not create any taxable income until the option is sold. (See our May-June 2004 issue at pg 6.) Even if TSOs were deemed to accrue a readily ascertainable fair market value at *vesting,* Reg §1.83-7(a) provides that taxation doesn't occur until exercise or disposition of the option.

As we have discussed, some companies and executives over the years have even sought to apply Section 83 taxation at grant, thereby garnering capital gain treatment for stock price appreciation after the grant date. The IRS has consistently resisted these attempts on various grounds.

Google also points out that the new Section 409A final Regs confirm (see Section 1.409A-1(b)(5)(v)(B)) that adding transferability to an option should not be a "modification" (creating a discounted option/NQDC where the option is in-the-money), because discretion to add transferability had already been reserved (as Google believes its plan does—see below). Adding transferability to an ISO obviously would turn the option into an NQSO; all of Google's post-IPO options are NQSOs.

Section 162(m). As for whether modification of an in-the-money option to add transferability in the auction program constitutes a new, discounted stock option grant for Section 162(m) purposes, possibly affecting the tax deductibility of top executives' related stock option taxable compensation, Google isn't concerned with that because they have excluded their entire executive group from the program. Companies desiring to (i) include in their TSO program executives who are subject to Section 162(m), or may become so prior to sale of an option, and (ii) modify their extant options, might take some comfort from PLR 9550124, which says that the amendment of options to allow gifts to family members isn't deemed a new grant under §162(m). (See our January-February 1996 issue at pg 9.) But, seeking IRS guidance is advisable on this one.

Plan Compliance/Amendment/Shareholder Approval

Adding the transferability of options to a stock plan would be a material amendment, requiring shareholder approval under SRO rules and, possibly, under the plan itself. However, well-drafted plans these days (*e.g.,* Google's) already allow options to be transferable, *e.g.,* "to the extent allowed by the committee." (See the May-June 1999 issue of *The Corporate Counsel* at pg 3.)

Section 16 Reporting. For those companies that may allow their insiders to participate, Alan Dye tells us that (i) Form 4 reporting of the grant of a transferable option is no different from reporting the grant of a typical non-transferable option; (ii) amendment to make an option transferable is not reportable (see Model Form 92 in Dye's *Section 16 Forms and Filings Handbook* (2005)); (iii) selling an option should be reportable in the same manner as selling a traded call option (see Model Form 143; if the term of the sold option shortens, the option disposed of still is the option based on its original terms, and should be reported that way); and (iv) exercise of an option by an unaffiliated person after sale of the option by an insider is not reportable.

1933 Act Registration Requirements

Google has had "extensive discussions" with the Staff regarding the registration requirements for all aspects of the program.

Google's Combo S-3. On April 20, Google filed a Form S-3 that includes (i) its 2004 Stock Plan (which originally had been registered on Form S-8) and (ii) the TSO buyers' anticipated hedging short sales (with a separate "Hedging Prospectus"). [Actually, Google's filing is on Form S-3ASR that is effective automatically upon filing. Google is a "WKSI," eligible to use S-3ASR (see the November-December 2004 issue of *The Corporate Counsel* at pg 5).]

SEC Form S-8, the traditional registration statement for employee stock options, isn't available for (exercise of) options that have been transferred beyond "family members." (See the March-April 1999 issue of *The Corporate Counsel* at pg 2.) But, the S-3 doesn't even apply to exercises by TSO buyers, and S-8 would still have been available for exercise of TSOs by employees (and family members). It's not clear why Google changed its stock plan registration to S-3. In the upcoming issue of *The Corporate Counsel,* we intend to explore S-8 vs. S-3 stock plan registration and to delve into other 1933 Act registration aspects of Google's TSO program.

Does Modification of Existing TSOs Involve a Tender Offer?

Google says it is "unilaterally" modifying all post-IPO options held by all eligible employees, even apparently those who haven't yet "enrolled" in the program. Thus, Google apparently has concluded that (despite the enrollment aspect of the program) applying the TSO program to extant options doesn't require (or involve) the consent of optionees, in that the program only adds features beneficial to the optionee (which the optionee is not even required to utilize); *i.e.,* enrollment is not consent but merely an election to participate in the program (and access bids online). (As discussed above, the modification of NQSOs has no adverse, or other, income tax consequences that may trigger a need for consents.) Thus, Google apparently has concluded that the SEC's tender offer requirements (see the July-August 2001 issue of *The Corporate Counsel* at pg 2) aren't implicated.

TSO Sales Subject to Insider Trading Blackouts

Even though the participating Google employees are not insiders, Google is not allowing TSO sales during any regular quarterly insider trading blackout period or during any other period when Google has determined that there is material non-public information relating to Google. Google says that the S-3 registering short sales may not be used while Google possesses material non-public information. It's not clear here whether they mean the S-3 can't legally be used, or whether they won't permit it to be used. As we have discussed, the ability to use an extant registration statement is not automatically affected by the existence of undisclosed material information. (See the March-April 2005 issue of *The Corporate Counsel* at pg 9.) But, Google and the short sellers obviously are concerned with potential disclosure liability for the registered, public short sales that would occur contemporaneous with any TSO sale. (Google is indemnifying the sellers from "underwriter" liabilities.)

Even 10b5-1 Plan Option Sales Blacked-Out. As our readers may recall, SEC Rule 10b5-1(c) insulates from anti-fraud liability transactions in company stock that are effected per a plan entered into at the time that the person is not aware of any material undisclosed information regarding the company. (See the September-October 2000 issue of *The Corporate Counsel.*) Most companies allow 10b5-1 plan sales of company stock during blackout periods (so long as the plan was entered into during a window period). But here, the real concern is the contemporaneous short sales triggered by TSO sales, which wouldn't be protected by a Rule 10b5-1 plan (more on this aspect also in the upcoming *The Corporate Counsel*). Thus, Google is not permitting TSO sales during any (quarterly or imposed) blackout period.

Interestingly, Google points out that a 10b5-1 plan for selling TSOs still might make sense, though sales will be suspended while non-public information is deemed to be extant, because option sales might end up being permitted by Google at a time that a court, etc. ultimately determines that there was, in fact, material non-public information; so long as there was no material non-public information at the time the plan was entered into, the Rule 10b5-1(c) defense would be applicable in that situation. Keep in mind that 10b5-1 plans are available even to non-executives/insiders. (See our September-October 2005 issue at pg 9.) Google makes available to all its employees a model 10b5-1 plan, which it has now updated for the TSO program.

Exercising Instead During a Blackout. Google initially intended to add to its blackout policy even normal option exercises via same-day sales. (Ordinarily, resales of option stock incident to traditional option exercises (same-day sales, etc.) are not made pursuant to a registration statement, and companies don't generally black out option exercises.) Apparently, Google's rationale here was that, since Google had seen fit to impose a blackout on all option *sales* because of the mere existence of inside information, then employees shouldn't be doing the equivalent of exercising/selling either. Ultimately, Google decided to apply blackouts only to *sales* of TSOs (*i.e.,* where there will be short sales pursuant to an S-3). Of course, insiders (and others who actually possess material undisclosed information) are blacked out by Google as to any transactions in Google securities.

Now, where an employee desires to cash-in their option during a blackout period, the employee can decide to forgo the TSO premium and, instead, exercise normally (realizing only the spread). It should even be possible to build that alternative (*i.e.,* option exercise) into a 10b5-1 option sale plan, *i.e.,* where an unscheduled blackout is in effect on a scheduled TSO sale date (or where a blackout is imposed near the expiration date of an option).

The Problem of Having to Announce a Blackout. As we have discussed, a big concern with imposing a (non-quarterly) blackout on employees generally (vs. only on insiders, and only when an insider notifies the company of a proposed transaction) is that there is a need to communicate the blackout to employees generally, suggesting that something big may be in the works. (See the September-October 2001 issue of *The Corporate Counsel* at pg 2.) Google foresees and attempts to ameliorate this problem by providing/disclosing that an imposed TSO sale blackout may occur for a "variety of reasons, including maintenance and other technical reasons." Nevertheless, we suspect that any blackout not specifically identified as solely technical will be seen by the marketplace as that something is astir. (Google also says that employees may not be provided advance notice of a blackout, implying they may be notified only when they seek to sell a TSO; thus, Google is saying it may even be able to avoid disclosure of an imposed blackout.)

Other Thoughts

Options Gifted to Family Members. Some stock option programs (but not Google's, apparently) permit optionees to gift stock options to those "family members" who are eligible to exercise via Form S-8. Those donees might, in turn, be able to sell in the TSO auction.

Share Dilution. All sold TSOs that are in the money at expiration will end up being exercised by the buyer (for cash), resulting in issuance of all shares subject to the option. But, at those companies where exercises generally are via same-day sale, that also results in issuance of the gross number of option shares. (Some companies might consider adding an SSAR feature to TSOs, or even granting TSSARs.)

While TSOs are outstanding, the EPS effect under FAS 128 would be no different for TSOs than for traditional employee stock options, except that after sale there would be no further assumed tax savings/share buyback that reduces the denominator (see our January-February 2006 issue at pg 4); pre-sale, the company presumably would assume tax savings based on the spread, not the bid price for an option.

The Option Grant Date Under FAS 123(R)

With all the focus these days on option dating, we thought it might be helpful to take a close look at what is required under 123(R) in order to establish the grant date.

Generally, the fair value of an award is computed on the grant date; any difference between the option price and the market value on that date will increase (if the option price is lower than the stock price), or decrease (if the option price is above the stock price), the fair value of the option (but, as we have discussed, not necessarily on a dollar-for-dollar basis, *e.g.,* a discount of $10 per share when the stock price is $50 might increase the fair value by only $3 per share and a premium of $10 per share might decrease the fair value of the option by only $3 per share—see our September-October 2006 issue at pg 6).

Under 123(R), the grant date generally is the date the company and the executive reach a mutual understanding of the terms of the option. This sounds simple enough, but there are nuances and wrinkles.

All Necessary Approvals Obtained

The grant date cannot occur until all corporate approvals required to issue the award have been obtained. Thus, where grants are to be approved via unanimous written consent of the comp committee (or the full board), in lieu of a meeting, the grant date would not occur until the signature of the last director to sign is obtained (although, in today's world, electronic/email approvals should suffice).

Delegation of Grant Authority. Keep in mind that option dating problems are not limited to grants to insiders. Thus, another "fix" here would be for the board or comp committee to delegate to, *e.g.,* the CEO (per Delaware GCL Section 157(c)) or the comp committee chair, authority to grant options below the officer/director level, which eliminates the need to obtain multiple approvals/signatures. Many companies have done this for years.

Pre-Set Grant Dates. We are also seeing more companies establishing annually in advance fixed dates when grants will be made. There are several catalysts here: Pre-determined dates suggest the company does not make it a practice to load up on grants when the stock price is down. Moreover, grants can be set for a few days after the announcement of quarterly earnings and guidance, as part of a policy of not "spring-loading" grants, *i.e.,* making grants just prior to the announcement of favorable information when the stock price may be about to rise. (A Delaware court recently held that spring-loading may be illegal—see Broc's February 7 Daily Blog on TheCorporateCounsel.net.) The new CD&A requirement to disclose the company's policy for the timing and pricing of grants (see our September-October 2006 issue at pg 7) would include disclosure of pre-set grant dates.

Pre-set dates may serve to alleviate to some extent the need to obtain every last approval signature on the grant date. Rather, grants could be documented in advance, in that it is OK to make, and document, grants that will become effective on a specified future date (see the March-April 2006 issue of *The Corporate Counsel* at pg 2).

Any Slack? While we would hope that the leeway for inadvertent administrative errors that the SEC Staff expressed in its September 19 accounting guidance (under APB No. 25) for past backdating (see our September-October 2006 issue at pg 2) will be applied also to current audit practice, companies obviously need to maintain rigorous documentation and sign-off procedures.

Grant Communicated (Eventually)

In order for both the company and the employee to have a mutual understanding of the terms of the arrangement, the employee must be informed of the key provisions of the grant, including the number of shares, type of award, price, vesting, and term. Although this 123(R) requirement also existed in the original FAS 123, it didn't generate much attention until late 2005 when the Big Four began to interpret it more conservatively than in the past (as mandatory expensing approached). (During the FAS 123 footnote-only/APB 25 regime, the general practice had been to assume the approval date was the grant/measurement date, notwithstanding when the grant ultimately was communicated to the employee.)

Initially, the auditors' position under 123(R) was that the grant date does not occur until the key terms are communicated to employees, which as a practical matter rarely occurs on the committee approval date and often doesn't happen until several weeks after the grant is approved. (In a September 2005 NASPP Quick Survey, only 11% of the respondents indicated that they communicate grants, *e.g.,* by distributing grant agreements, within one week of the approval date; 67% take one to four weeks; and the remaining respondents take even longer.)

Enter FAS 123(R)-2. In response to the general outcry that resulted (and, perhaps in part, to the NASPP's comment letter on the matter), FASB issued Staff Position FAS 123(R)-2 on October 18, 2005, which says that a mutual understanding is presumed to occur at the time a grant is approved by the board/committee, provided that (1) the executive does not have the ability to further negotiate the terms of the award and (2) the award is expected to be communicated to the grantee within a "relatively short period of time after the approval date." It is not necessary that the grantee return a signed copy of the agreement within that time frame.

Requirement (1) normally shouldn't raise questions, even where there is a possibility that the award won't be accepted by the grantee (*e.g.,* by a foreign employee because of local tax quirks). But, if an executive is able to further influence the terms, *e.g.,* to negotiate a more favorable vesting schedule, that would defer the grant date to when the award is finalized.

A Relatively Short Period of Time. According to 123(R)-2, the communication limit of requirement (2) is the time in which the company could reasonably communicate the award to employees in accordance with its customary practices. This is a facts and circumstances test that will vary by company, and possibly even by award recipient within a company (thus, executives would normally be advised of an award right away so they can meet the two-day filing deadline for Form 4).

Companies that electronically distribute grant agreements could reasonably be expected to effect communication faster than where managers meet with their group members to distribute paper grant agreements. Likewise, it would be reasonable to expect that grants would be communicated (and grant agreements distributed) to U.S. employees faster than with overseas employees.

A Few Weeks Probably OK. We suspect that those companies that distribute grant agreements in under a month probably don't have anything to worry about, but companies that are taking longer may want to tighten up their procedures (or at least verify with their auditor that their procedures won't cause a delay in establishing the grant date).

Dispensing With Grantee Signatures? Generally, companies still require grantees to sign a grant agreement manually (or, these days, electronically). The desirability that grantees acknowledge and agree in writing to the terms and conditions of a grant is obvious. But now, some paranoia may be developing, in that the process of obtaining signatures further strains the 123(R)-2 paradigm (obviously, if the mere communication of grants takes, say, 30 days, the signing process, which is not totally within the company's control, can only extend that period further—and could even raise ability to negotiate/requirement (1) questions).

We have heard that some companies are even considering a legal bifurcation in response to this latest concern, to the effect that the *grant* is not conditioned on (and doesn't require) grantee signature but that *exercise* of the option (or vesting of RS/RSUs) is conditioned on the grantee ultimately signing the grant agreement. Some companies may even be considering dispensing with grantee signatures altogether. We had thought 123(R)-2 (which, as mentioned above, contemplates grantee signing but doesn't require that a signed agreement be returned, only that the grant be expected to be communicated, within "a relatively short period of time") would have settled the matter, and that the Big Four would provide comfort that stems (rather than fans) this overreaction. In most situations, with broad-based grants, grantee signatures are a mere formality in any event.

Price Established

Under Paragraph A.77 of 123(R), the grant date doesn't occur until "an employee begins to benefit from, or be adversely affected by, subsequent changes in the price of the employer's equity shares." Thus, the price at which shares can be purchased under the award must be set. If the board approves an option where the price will not be set until a future date (including a grant which provides that the price might change based on stock price fluctuations prior to communication of the grant to the executive, as a possible substitute for backdating—see our September-October 2006 issue at pg 6), the grant date does not occur until the price is finally set.

Indexed Options; ESPPs. There are some exceptions to the general pricing requirement, however. For example, with an indexed option, *e.g.,* where the strike price adjusts post-grant based on a pre-set standard (see our March-April 2000 issue at pg 8), the grant date can still occur on the approval date. Ditto for ESPPs, where the grant date is generally the enrollment date, even though the purchase price usually is not fixed until the purchase date.

With both ESPPs and indexed options, although the price is not fixed at grant, there is a pre-set formula by which the executive begins to be economically impacted by fluctuations in the stock price. In addition, FASB believes that there is enough of a relationship between the grant date stock price and the ultimate purchase price to allow grantees to understand the compensatory nature of the arrangement. (In the case of an ESPP, a *maximum* purchase price is established on the enrollment date and, in the case of an indexed option, the ultimate price is a function of the current price and the index; both can be evaluated at the grant date by an option pricing model.)

Performance Goal Defined

Where vesting is contingent on performance, the target or goal must be defined (not met) before the grant date is considered to have occurred. Thus, where the committee approves a grant that will vest upon attainment of a performance category (*e.g.,* EPS), but leaves it to later to set the actual target (*e.g.,* $.60 per share), the 123(R) grant date will be the date the performance target is finally defined, not the date the award was originally approved. (But, in determining whether options were discounted for Code Sections 409A and 422/ISO purposes, 123(R) is not dispositive so the grant date in this situation may still be the initial approval date.) The ultimate setting of targets should be documented in committee minutes, just as the initial grant was documented; auditors obviously are looking for complete documentation these days.

Service Inception Date vs. Grant Date

123(R) distinguishes between (i) the service inception date, which is the date the service period under the award, and amortization, begin (*i.e.,* the date the executive begins earning the award), and (ii) the grant date. In most cases, these two dates are the same, but sometimes the service/amortization date precedes the grant date. [The service inception date can also come *after* the grant date if the employee does not immediately begin performing the services required to earn the award, although that would be unusual. The most likely example is a performance-based award with multiple, unrelated targets, *e.g.,* a portion of the award will be paid out in one year based on earnings for that year and the remainder of the award will be paid out in two years based on earnings for the second year. In this example, because the payout for the second year is not dependent on the first earnings target, the service period for the second target would not begin until the start of year two.]

<u>Marking-to-Fair Value Where Service/Amortization Begins Prior to the Grant Date.</u> An example where the service date would commence (and expense begin to be incurred) prior to the grant date would be where the board authorizes a fully vested option to be granted to an executive in 12 months at a price equal to the market value at that time, the grant date would not occur until a year later, when the option price is known, but the company would begin to recognize expense for the option during the year preceding the grant date (using a mark-to-fair-value approach, because fair value can't be measured until the grant date).

A more likely example is where the board approves options that will be granted (and begin to vest) in the future only if certain performance or market conditions are achieved by a specified date. For example, the board might approve options in early 2007 to be granted in early 2008 if 2007 earnings targets are met. The options, once granted, will be subject to the standard vesting schedule under the plan and the option price will not be set until the grant date in 2008. Here again, the service inception date would be the upfront approval date, even though the grant date won't occur until the price is set. Thus, the company would begin recognizing expense for the options during the year prior to the grant date (again, using a mark-to-fair-value approach). Once the grant date occurs, the expense for the options would be fixed and the remaining expense would be recognized over the vesting period.

<u>Except Restricted Stock.</u> If, however, the grant in this example were restricted stock (which is the accounting equivalent of a stock option with an exercise price of $0), the grant date would be the 2007 approval date (since the price and all terms would be known at that time), eliminating mark-to-fair-value accounting. This might be one more reason why restricted stock may be a better tool for some performance-based arrangements (see our January-February 2004 issue at pg 1).

<u>Scope of Approval Can Affect Service Inception.</u> The scope of the initial approval impacts whether not a service inception date has occurred. Where the initial approval specifies the number of shares employees will receive, it is clear that the service inception date will be the approval date. Likewise, where the initial approval does not specify award size (or even an aggregate number of shares), but leaves that to be determined on a discretionary basis when the grants are made, the service inception date would not occur until the grant date (and mark-to-fair value accounting would not apply).

<u>Negative Discretion Can Delay Grant Date.</u> To qualify as performance-based compensation under Code Section 162(m), our readers may recall that the compensation cannot be discretionarily *increased* at the end of the performance period. But, the §162(m) Regs do allow the compensation committee to discretionarily *decrease* the amount of payout earned; this type of "negative discretion" award is common. This facilitates setting "lenient" performance targets,

while allowing the company to still treat the compensation as performance-based and, thus, tax deductible without regard to §162(m)'s $1,000,000 limit. (See our January-February 1994 issue at pg 2.)

Some accounting firms are now saying that negative discretion delays the grant date to the date the payout is determined because, since it creates uncertainty as to the amount that will be paid out, a mutual understanding of the terms and conditions does not exist upfront. Thus, because the executive has begun performing the services required to earn the awards, the service inception date would occur at the initial approval, *i.e.,* prior to the grant date; triggering mark-to-fair value accounting until the grant date.

Unilaterally treating all awards with negative discretion as not granted until paid out seems overly conservative, however. Our friends at Mercer, who pointed this development out to us, suggest that, at a minimum, where a company has not historically exercised negative discretion (to reduce payout) or where the compensation plan is crafted in a manner which makes it unlikely that the provision will be used (*e.g.,* where negative discretion can only be exercised in unusual circumstances), the initial approval date should still be treated as the grant date. Nevertheless, companies should review this issue with their auditors and may need to tighten up these plans.

<u>New-Hire Grants.</u> How does the service/grant date play out in the context of grants to new hires? First, companies generally don't make grants prior to the actual employment start date; doing that would unnecessarily invoke the non-employee grant side of FAS 123(R), *i.e.,* mark-to-fair-value accounting until the start date. A company might agree in the hire letter to make a grant on the start date at the price on that date. There, even if vesting starts based on the hire-letter date, there is no pre-grant service period.

Shareholder Approval of Executive Compensation—Israeli Law

As noted by Broc Romanek in his April 21 daily blog on TheCorporateCounsel.net, the House has passed Rep. Barney Frank's legislation requiring shareholder approval of executive compensation. Moreover, Aflac has announced that it will submit its executive compensation for shareholder approval at its 2008 annual meeting. And, AFCSME, etc. are busy submitting shareholder proposals seeking same.

Thus, we took a look at the August 24, 2006 proxy statement of Teva Pharmaceuticals, where management (at a special rather than annual meeting) solicited shareholder approval of the compensation arrangements of Teva's two top executives, as required by Israeli law for executives who are also board members. Teva points out that Israeli law is "stricter than the legal requirements for U.S. companies" in this regard.

Perks, Etc.

We are intrigued by the following disclosure in Teva's solicitation: "Teva will also continue to provide Mr. Hurvitz with an office and with secretarial and car services and will, in accordance with the Company's Articles of Association, also reimburse him for other reasonable and necessary business expenses incurred in the course of his service to the Company."

This disclosure brings to mind the parameters that shareholder approval would bring to the compensation process. Even though complicated employment agreements might end up being submitted for approval, at least parameters would be disclosed, and *ad hoc* additions (*e.g.*, perks) would be reined in.

Existing "Requirements" for Shareholder Approval of Executive Compensation

Code Section 162(m)'s performance compensation exclusion essentially mandates shareholder approval of incentive compensation, but only generically and only and every five years (see our September-October 1996 issue at pg 10). The SRO requirement for shareholder approval of equity plans is similarly generic. While state corporate laws generally provide for shareholder approval as a means for validating a transaction with a director or officer (including compensation), *e.g.,* DGCL §144 and Cal GCL Section 310, Keith Bishop of Buchalter Nemer in Irvine points out that approval merely by the disinterested directors accomplishes the same purpose.

Absent a federal law requiring shareholder approval of CEO/NEO compensation, states might consider doing so. While state law requirements wouldn't be uniform, or universal, and some might say would portend a race to the bottom (*i.e.,* to states that don't require approval), we don't see this being any different from other state of incorporation considerations that still exist today (*e.g.*, majority voting requirements). With today's investor sensitivities, blatant forum shopping is now on the radar screen.

Three 'Must' Conferences—In One!

We have just posted the agendas for the three major Conferences that we will be holding in San Francisco during our "October Conference Week for Counsel". Because of their importance, we will be televising the conferences via Live Nationwide Video Webcast. We are looking forward to seeing many of our loyal readers in San Francisco. (If you can make it, there will also be two post-conference Gala Events, with big name entertainment). But, for all those that can't make it out here in October (the best time of the year in San Francisco), see the special 'Member Appreciation Package' below.

"Tackling Your 2008 Compensation Disclosures"

Our "2nd Annual Proxy Disclosure Conference" will be big. As all those who attended last year's conference can attest, this is the definitive conference for everyone involved in preparing, drafting, reviewing—or providing advice regarding—your proxy compensation disclosures. The new requirements and higher expectations for the 2008 disclosures may, in many respects, be more demanding than this past year—with greater potential consequences.

You will want to make sure that all your people hear each and every one of the panels. Last year, over 5,000 people attended this conference in person and via the Nationwide Live Video Webcast. This year's audience will be even larger.

The 4th Annual Executive Compensation Conference: "Lessons Learned"

Everyone attending the "2nd Annual Proxy Disclosure Conference" will need to also attend this key conference. This major one-day conference has taken on *heightened importance* under the SEC's new executive compensation rules. The regulators and the critics are not happy with the failure of many companies to provide meaningful "Analysis" in their 2007 CD&As (*e.g.,* see John White's recent speech). For 2008, all eyes will be focused on the "Analysis" section of the CD&A and the need to address the *tools* that compensation committees are utilizing—and the resulting findings and actions. As a result, this Conference will be a "must" for anyone who has any role in the preparation or review of proxy statements. A glance at the enclosed agenda will give you a hint at why this Conference will be so critical for each of us.

Our 1st Annual "*The Corporate Counsel* Speaks" Conference

Yes, for years, our loyal readers of *The Corporate Counsel* have asked us to provide the type of practical guidance we have become known for—in a Conference format. We have listened! At this Conference, our readers will be brought up-to-speed on the latest innovations and developments that you are grappling with (*e.g.,* Google's transferable options program). And, you will get the latest thinking from the foremost experts on "bread and butter" daily practice topics. This conference will also cover the latest proxy season challenges, such as the implications of e-Proxy and how solicitation strategies need to change, as well as a lightning "nuggets" round on avoiding costly executive compensation disclosure mistakes. And, Alan Dye and yours truly are putting together a "Ten Preventive Nuggets in 15 Minutes" session that will be designed for our readers to play over and over (for your executives and anyone involved with insiders' transactions).

"Member Appreciation Package"—Early Bird Rates

As you will see in the enclosed, because it is important to us that every person involved in the process gets the benefit of these important Conferences, and as a way of saying "thank you," we are providing very special rates for those attending all three conferences via the Nationwide Live Video Webcast. Note that we have provided the steepest discounts for those who will be taking advantage of the "unlimited" and "firmwide" categories to ensure that everyone at companies and firms will have ongoing access to the archives and the materials, even after the conferences. Also, don't overlook the Early Bird special rates (which expire on June 30).

Global Warming and the Impact on Corporate Law and Boards

On June 12th, learn how climate change will impact your daily practice during a full-day TacklingGlobalWarming.com webconference: "Tackling Global Warming: Challenges for Boards and their Advisors." As a "thank you" to our readers, this webconference will be provided on a complimentary basis and will provide guidance on, among other topics:

- The Board's Perspective: Strategic Opportunities and Fiduciary Duties
- Why You Need to Re-Examine Your D&O Insurance Policy
- The Investor's Perspective: What They Seek and Their Own Duties
- Disclosure Obligations under SEC and Other Regulatory Frameworks
- How (and Why) to Modify Your Contracts: Force Majeure and Much More
- Due Diligence Considerations When Doing Deals

Catch these Upcoming "Hot Topics" Webcasts:

– "The Nasdaq Speaks: Latest Developments and Interpretations" (TheCorporateCounsel.net; June 5th)

– "How to Implement E-Proxy: Avoiding the Surprises and Making the Calculations" (TheCorporateCounsel.net; June 14th)

– "The Latest Compensation Disclosures: A Proxy Season Post-Mortem" (CompensationStandards.com; June 20th)

– "The Art of the Cross-Border Deal" (DealLawyers.com; June 7th)

– "Reverse Mergers: Latest Developments" (DealLawyers.com; July 11th)

Just Announced! Half-Price for "Rest of 2007"

As our memberships to our publications and websites expire at year end, we have just announced a half-price "Rest of 2007" offer for most of our publications, including *The Corporate Counsel* and *The Corporate Executive*; TheCorporateCounsel.net; DealLawyers.com; Section16.net; CompensationStandards.com—and our popular new M&A print publication: *Deal Lawyers*. You can order online on any of our sites or contact us today.

—J.M.B.

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