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THE NEWSLETTER FOR THOSE THAT ADVISE PUBLIC COMPANIES

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Why Companies Should Now be Implementing "Net Exercises" —Everything You Need to Know

A Word from the Publisher

As our readers may have noticed, now that David Lynn, former SEC Chief Counsel, has joined the team—providing important proxy disclosure guidance and other critical practical guidance—*The Corporate Executive* has become a "must" for an even larger audience.

As demonstrated by the lead article in this issue, we continue to provide you with the latest developments and innovations impacting your most important "clients." We are devoting this entire issue to net exercises and their alternatives because this exciting new trend is so important and will affect so many companies.

For those of you on the fence about net exercises, we start the article by enumerating the many advantages these programs offer over traditional cashless/same-day-sale exercises. Starting on page 2, we provide an in-depth explanation of the mechanics of net exercises and their various alternatives: stock-settled SARs and pyramid and swap exercises. On page 4, we discuss practical solutions for handling the tax withholding required for these transactions and, on page 6, we explain why ISS's position on liberal share-counting provisions shouldn't discourage companies from implementing net exercise, etc., programs. We conclude the article with step-by-step instructions for implementing your own net exercise program.

Based on the SEC's most recently published rulemaking agenda, it appears that the agency is poised to take a fresh look at the executive compensation disclosure rules. This latest effort is necessitated by the SEC's adoption of relatively unusual "interim final" rules back in December 2006—and creates a perfect opportunity to address some aspects of the rules that could use clarification or improvement now that the Staff has completed its targeted review of proxy disclosures. In a Special Supplement to this issue, we outline four critical fixes that the SEC may want to consider to make the rules operate as effectively as possible—and provide the type of disclosure that investors and others are actively seeking about executive compensation. We certainly hope that the SEC will consider these fixes in fine-tuning the rules for next year's proxy season so that the momentum toward improving executive compensation transparency and practices continues.

—*Eds.*

Net-Settled Options: The Silver Lining in FAS 123(R)

While opinions may vary as to whether FAS 123(R) overall has been good or bad for business, we think that everyone can agree that one silver lining in the standard is the elimination of adverse accounting treatment for stock-settled stock appreciation rights and pyramid and net exercises. Under APB Opinion No. 25, all forms of stock appreciation rights, whether settled in cash or stock, were subject to variable plan accounting. Ditto for any option exercise that did not involve either an inflow of cash to the company (either from an open market sale or the employee's pocket) or tender of shares that had been owned for at least six months to cover the exercise price.

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Under FAS 123(R), all this noise goes away, provided that the option or right will ultimately be settled in stock. The requirement that shares tendered to cover the exercise price be held for six months is eliminated, enabling net exercises, as well as pyramid exercises and stock-settled SARs, to receive the same accounting treatment as cashless/same-day-sale exercises.

Time to Switch from Cashless Exercises to Net Exercises

With the accounting treatment no longer an obstacle, we think it's time for all companies to consider implementing "net exercises"—or stock-settled stock appreciation rights—as these arrangements offer considerable advantages over traditional cashless exercise/same-day-sale programs, including:

• Net exercises and SSARs, etc. provide the very same economic benefit to employees as cashless exercises but result in fewer shares issued and sold into the market. (The economic benefit to employees is actually slightly better because the brokerage commission is saved.)

• By reducing the number of shares issued, net exercises and SSARs reduce plan dilution. (One issuer has calculated a savings of 70% fewer shares over the life of the plan—see pg 7.)

• The reduced flow of shares into the market also alleviates the need for company repurchase programs, which can be administratively burdensome and often require execution under Rule 10b5-1 plans and compliance with Rule 10b-18.

• With net exercises and SSARs, companies may be able to disclose a lower number of the shares as outstanding under Reg S-K Item 201 (the stock plan table).

• Switching to net exercises or SSARs can extend the life of your stock plan by increasing the number of shares available for grant (if the plan includes a net counting provision).

• Net exercises and SSARs can eliminate the many administrative hassles and fees involved in same-day-sale exercises—including the headache of employees having to report capital gains or losses due to differences between the actual sale price and the reported FMV.

• Net exercises and SSARs can mitigate insider trading compliance concerns (both short-swing profits recovery and insider trading considerations) by eliminating open market sales to fund exercises.

• For insiders/affiliates, net, pyramid, swap and SSAR exercises are not reported as an open market sale on Form 4. Instead, provided that no shares are sold to cover taxes, the settlement is reported as a simultaneous exercise and disposition of shares to the company and does not require a Form 144.

• Net exercises can result in executives holding the net shares for the long-term (and can facilitate "hold-til-retirement" policies for top executives).

What You Need to Know About Net Exercises and SSARs

Net exercises and SSARs provide the same economic benefit to employees as cashless exercise/same-day sales, but do so with fewer shares. Just as with cashless exercises, upon exercise, employees receive the stock price appreciation that has accumulated in the option since it was granted. But with stock options, employees must first pay the exercise price to receive the stock underlying the option (which is sold immediately into the market to cover the cost of the transaction). In the case of a net exercise, the employee simply receives the net shares representing the "gain" on the option—the difference between the exercise price and the current FMV, thus eliminating the need for an immediate open market sale (except possibly to cover taxes, see below).

For example, assume an option for 100 shares is granted when the FMV is $10 per share and exercised when the FMV is $25 per share. To exercise the stock option under traditional methods, the employee must come up with $1,000 to pay the company, almost always selling the exercised stock in a cashless exercise/same-day sale to do so. The company then issues all 100 shares underlying the option—but the shares are issued to the employee's broker and immediately used to settle the employee's trade—the employee sells them before even owning them. The employee would have realized approximately $2,500 on the sale, resulting in a profit of $1,500 (less any brokerage commissions, etc.).

On the other hand, with a net exercise or an SSAR, the employee pays nothing for the exercise; instead, the employee simply receives $1,500 worth of stock, or 60 shares ($1,500

divided by $25). Instead of issuing 100 shares, the company issues only 60 shares. There is no need for a sale into the market to pay the exercise price, increasing the likelihood that employees will hold on to their shares (and facilitating hold-til-retirement policies for top executives). No sale also means no Form 144, no sale reported on Form 4 (although it would still be necessary to file a Form 4), and fewer concerns over insider trading.

With only 60 shares issued instead of 100, the net exercise is less dilutive to shareholders. In addition, if dilution is not a concern, the 40 unissued shares could potentially be returned to the plan reserve and made available for new grants.

Net Exercises vs. SSARs. Both net exercises and SSARs deliver the same economic benefit in essentially the same manner; the difference between the two rights is really more in semantics. We prefer net exercises over SSARs. With net exercises, employees have traditional options; there is no separate instrument to deal with administratively and no learning curve for employees to understand the new instrument. Upon exercise, the company essentially withholds shares sufficient to cover the exercise price. The net exercise in our example involves the deemed issuance to the employee of all 100 shares, and "sale" back to the company of 40 shares to pay the exercise price (40 shares x $25 = $1,000). Net exercise (originally dubbed the "immaculate exercise" by us—see the January-February 1993 issue of *The Corporate Counsel* at pg 6), wasn't feasible until 123(R) came along because of the old "mature shares" requirement that shares sold or exchanged back to the company to pay the exercise price of an option be held for at least six months to avoid mark-to-market variable accounting (see our January-February 1998 issue at pg 5).

[With SARs, employees don't actually have a right to purchase stock; instead they have the right to receive the appreciation accumulated in the stock underlying the right. In a stock-settled SAR, this appreciation is paid out in stock, based on the current FMV. Thus, the employee ends up with the same number of shares as under a net exercise. In our example, under an SSAR, the employee is entitled to a payment of $1,500 (the spread at exercise) or 60 shares ($1,500 divided by the $25 FMV).

SSARs can be granted in tandem with a stock option or on a standalone basis. If granted in tandem, employees have both an option and an SSAR; choosing to exercise one cancels an equal number of shares in the other. This type of tandem arrangement is more common for cash-settled SARs, where a portion of the SAR might be exercised to obtain the cash necessary to fund exercise of the remaining option. In the SSAR context, we expect standalone arrangements to be the more common approach.]

With net exercises, the company could continue to permit alternative exercise methods, such as paying cash to exercise the option. The same objective could be accomplished with an SSAR by granting it in tandem with a stock option.

Not permissible for ISOs? We have noted that SSARs cannot receive ISO treatment (see our November-December 2004 issue at pg 1) because they are not options; there is also some

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[illegible] the employee really holds an "option" to buy stock or merely a right to the appreciation of the underlying stock. Thus, under a conservative reading of the tax code, allowing net exercise of ISOs could disqualify not only the tendered shares but the entire option.

Automatic Net Exercise at Expiration. We have long been a proponent of options that are automatically exercised if in-the-money at expiration (see our March-April 1999 issue at pg 7). Now, with the potential tax expense that can result under FAS 123(R) from these expirations (see our January-February 2005 issue at pg 2), this idea seems to have even more merit. Pre-123(R), we suggested automatic same-day-sale exercise, but now net settlement seems like a better alternative. It avoids the waste of expired options (with no reversal of previously recognized expense), without the hassles (and commissions) of a same-day-sale exercise and delivers shares (rather than cash) to employees.

Other Alternatives—Swap and Pyramid Exercises. 123(R)'s elimination of the mature share requirement also facilitated the tender of already-

owned shares to pay the exercise price of an option (a stock "swap") and clears the way for pyramid exercises.

Swap Exercises. [illegible]

[illegible]

Pyramids. [illegible]

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[illegible] see the summary of the tax basis under the various alternatives in the NASPP's "Net Exercises Comparison Chart: Outcomes and Considerations."]

Covering the Tax Withholding. Net exercises and SSARs are taxed in the same manner as NQSOs: employees recognize ordinary income equal to the spread at exercise. Likewise, if swap and pyramid exercises are performed on NQSOs, they are subject to the same tax treat-

ment. The ordinary income recognized upon exercise is subject to the same tax withholding that applies to cashless/same-day-sale exercise of NQSOs (including FICA), and reported on Form W-2 for employees (Form 1099-MISC for outside directors and other non-employees).

Of these three alternatives, share withholding is the easiest from an administrative standpoint.

But this tax treatment may not be as significant a disadvantage as it first appears. Even with a traditional cashless exercise/same-day sale,

A Big Administrative Advantage Over Cashless Exercises. Share withholding resolves these is-

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Avoiding an open market sale can also ease compliance with insider trading blackouts (depending on the language of the company's insider trading policy) and mitigate Rule 10b-5 concerns and the need for complicated Rule 10b5-1 trading plans. [Note also that, as long as the tax withholding right was approved in advance by the board of directors, a committee

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Share Counting—Good News and Bad News. At the 2007 NASPP Conference, SSAR guru Art Meyers of Seyfarth Shaw in Boston mentioned one potential snag for companies that want to

the outstanding options were exercised via net, swap, or pyramid transactions, the shares returning to the plan as a result of these exercises would more than cover the grants for the year (and remember, the company doesn't really need 1,000,000 shares to cover the net-settled options since only a portion of the shares granted will be issued on exercise).

Where a company decides it doesn't want to risk the uncertainty that the shares flowing into the plan from exercises will offset the reduced number of shares approved for the plan by ISS, the company could always forego net counting. This would put net-settled options, etc., on par with cashless exercise/same-day-sale options in ISS's analysis and would increase the number of shares ISS would approve for the plan back up to what would have been approved before net exercises. In terms of the shares available for grant under the plan, the company would be no worse off than with traditional stock options but the company would still enjoy the other benefits of net-settled options, etc., (reduced or eliminated flow of shares into the market, lower dilution, less pressure to repurchase shares, streamlined plan transactions, fewer insider trading concerns, etc.).

Keep in mind that this issue only arises if and when a new plan or amendment is submitted for shareholder approval.

Real EPS Impact—Another Plus for Net Exercises. The impact of net exercises and their alternatives on diluted earnings per share is the same as that of traditional option exercises. For options that [illegible] methods, and [illegible] company acq[illegible] and then issu[illegible] to repurchase [illegible] market. With [illegible] its alternative[illegible] appreciation accumulated in the underlying stock are issued, producing the same end result under the Treasury Stock Method as for traditional exercises. (The various sources of exercise proceeds in addition to the exercise price (tax savings and unamortized expense) are also applicable to options with a net exercise provision (and their alternatives) are calculated in the same manner as for options that will be exercised via same-day sale, and are assumed to be used to repurchase company stock, just as for options that can be exercised via same-day sale (see our January-February 2006 issue at pg 4).

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The impact of net exercises, etc., on basic earnings per share, however, could be quite different. In our earlier example, we contrasted a same-day-sale exercise with a net exercise: the same-day sale resulted in the issuance of 100 shares vs. 60 shares for the net exercise. Once these shares are issued, the Treasury Stock Method no longer applies. Instead, the shares are included in the denominator for basic EPS on a share-for-share basis. Thus, the same-day sale in our example increases the denominator for basic EPS by 100 shares; the net exercise increases the denominator by only 60 shares.

Over time, shares issued under plans add up. For most public companies, their stock plans are the predominant source of shares flowing into the market; many have to implement costly repurchase programs to offset the shares issued. With net-settled options and their alternatives, this flow of shares into the market is markedly decreased. Duke Realty implemented a pyramid exercise program when they adopted FAS 123 in 2002. During an NASPP webcast in 2006, Valerie [illegible], Duke's Senior Manager of Equity Compensation at the time, reported that they estimated that if they'd had the program in place from the initial implementation of their stock plan, they would have issued 70% fewer shares.

SARs OK Under Section 409A. We're not doing a Section 409A tome here, but SSARs enjoy essentially the same exemption from Section 409A/NQDC that NQSOs do. Originally, all SARs would have been subject to Section 409A; [illegible]-settled SARs [illegible] final Regs, sti[illegible] [illegible] that if the [illegible] can never [illegible] price, [illegible] the [illegible] never be less [illegible] the SAR does not provide for any deferral of income beyond the date of exercise.

Proxy Disclosure. An in-depth discussion of all the executive compensation disclosures that are applicable to net-settled options and SSARs is also outside the scope of this article. Suffice it to say that net exercises and SSARs are generally subject to all the same disclosure requirements as traditional stock options. Moreover, when disclosing net, swap, pyramid, and SSAR exercises in the Option Exercises and Stock Vested Table, the aggregate number of shares exercised should

[illegible] On the other hand, when disclosing the number of shares the executive could acquire in the next 60 days in the Beneficial Ownership of Management Table, the company would calculate the number of shares issuable [illegible]

In the S-K Item 201(d) stock plan table, however, [illegible]

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[illegible]

In terms of the S-K Item 703 disclosure relating [illegible]

Section 16 Reporting. Alan Dye's Section 16 Forms and Filings Handbook (2005 edition) contains model Forms 4 for net exercises (Model Form No. 109), SSARs (Model Form Nos. 111 and 112), pyramid and swap exercises of an option [illegible] [Don't forget to make sure that the tax withholding right as well as net exercises have been [illegible]

A further advantage here is that all of the shares tendered to the company to cover the option price (and taxes) would be valued at the same price and could be reported as a single transaction, as opposed to the numerous transactions (sometimes over 30, requiring multiple Forms 4) that are necessary for cashless/same-day-sale exercises where shares are typically sold in many different lots, at many different prices, each triggering a separate reportable transaction.

How to Implement Net-Settled Options, Etc.

Step 1: Shareholder Approval—Often No-Need. The first step in the process will be to review your stock plan to see if [illegible]

Generally, amending a plan that provides for the grant of traditional stock options to allow [illegible]

engage in swap, pyramid, or net exercises doesn't implicate any of those actions and shouldn't require shareholder approval under NYSE listing requirements. Moreover, the NYSE has said that options and SARs are the same "type" of award, therefore adding SARs to a plan that already allows traditional options is not considered a material amendment (NYSE FAQ C-3).

[illegible]

Amending your plan to allow net counting, [illegible]

Step 2: Make Critical Plan Design Decisions. In as much as net exercises, SSARs, etc. deliver [illegible]

[illegible]

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gain and tax withholding upon exercise—it may be necessary to amend this provision.

Another seemingly insignificant issue that could have bigger implications is rounding. It is rare [illegible]

Step 3: Consider International Employees. Companies with employees outside the United States will also have to evaluate the new pro- [illegible]

Step 4: Update Plan Documentation. Since the issuance of shares pursuant to net exercises, SSARs, and the various exercise methods we discuss are covered by Form S-8, it shouldn't [illegible]

It also may be necessary to draft new [illegible]

need to be filed as exhibits to Forms 10-Q/K and current disclosures may be necessary under Item 5.02 of Form 8-K if the plan includes executive officers.

Step 5: Amend Existing Options? Again, Good News. Steps 1 and 2 above take care of new grants, but what about your existing options?

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Surprisingly, however, the amendment would

Ditto for Section 162(m) and Section 16—no

Step 6: Educate Employees and Reap Benefits. If adding net exercises, pyramid or swap or an

may be skeptical at first, through examples and illustrations you can demonstrate that they are receiving the same economic benefit as previously under the cashless exercise/same-day sale program, with the added benefit of no brokerage fees. Net exercises are probably the easiest to communicate; employees still hold the same options they held before (perhaps new grant agreements might not even be necessary) and are just exercising via a new procedure—one that isn't all that far off from the cashless exercise/same-day sale procedure they are used to. There are no complications such as the need to already own stock to effect an exercise or the convoluted transactions involved in pyramid exercises.

This is also the time to distribute any paperwork necessary, such as updated grant agreements, prospectus, etc., if necessary. [Don't forget to also take advantage of this opportunity to remind executives of the company's insider trading policies and procedures—while at the same time explaining how net exercises can alleviate insider trading, Rule 144 and Section 16 complications, since open market sales are not involved (if shares are not sold to cover taxes).] Then the company, employees and executives can begin enjoying the numerous benefits of net-settled options!

Go to It!

Most companies should now be switching from their current cashless exercise/same-day-sale program to net exercises—which will be a "win" for companies, employees, insiders, and administrators. And, brokers who currently handle cashless exercises can reap benefits.

Savvy brokers will recognize that the miniscule commissions they currently receive from cashless exercises do not cover the brokerage firm's administrative costs of processing such transactions. The real benefit to the broker is the professional relationship and other business that can be developed with the company and its executives. We expect that the best and most professional brokers will now see the benefit of being the first to bring to their clients' attention the benefits of net exercises over cashless exercises. Looking out for their clients' long-term interests (over the broker's slight commission loss—really not a loss, just a delay until the employee sells the net shares) will strengthen the broker's relationship and surely pay dividends over the long term. (And, don't overlook that some brokers will still need to facilitate same-day sales to cover tax withholding).

In short, go to it!

[The NASPP has just posted (at Naspp.com) a helpful chart comparing cashless/same-day-sale exercises to net exercises and their various alternatives, as well as a one-page summary of the benefits of net exercises over cashless/same-day-sale exercises. Those few subscribers who may not yet have discovered the benefits of the NASPP can take advantage of the no-risk trial at Naspp.com to gain access to these helpful materials—and to take advantage of the significant savings, especially the more than 50% discount on registration to this year's NASPP Annual Conference.]

—J.M.B.

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With two year's worth of proxy seasons under our belt, trends are emerging—and many open issues have arisen—regarding how to comply with the SEC's latest executive compensation positions and what to do about the new executive compensation tools and expectations. With Congress, the SEC Staff, investors and the media scrutinizing the disclosures, it is critical to have the best possible guidance. This pair of full-day conferences will provide the latest essential—and practical—implementation guidance that you need.

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