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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.



2 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 consider-

ations) 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 an 100 shares, and "sale" back to the company of 40 shares to pay the exercise price (40 shares \times \$25 = \$1,000). Net exercise (originally dubbed the "amalgamate exercise" by us—see the January-February 1963 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 9) because they are not options; there is also some

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on 10/10/05, there is some question as to whether 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-

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

Swap Exercises. A swap exercise is relatively straightforward: employees simply tender shares they acquired previously that have a value equal to the price of the option they are exercising. In our example, the employee would already own 40 shares and would tender those shares to exercise the 100 shares in his/her option. From a practical standpoint, this is usually accomplished through a process referred to as “assignment” (see our November-December 1996 issue at pg 6). The employee doesn’t actually deliver the 40 already-owned shares in the company; instead the employee simply attests to owning these shares and the company issues only the net 60 shares—the same results for net exercise and SSARs.

The tax property, net shares (see Thus, the gain at the tion of the to the net tax basis is so that when the employee eventually sells the shares acquired on exercise, the employee will recognize a capital gain on the difference between the sale price and the original basis of those shares. Of course, if the option is an NQSO, all the usual taxes required upon exercise are still applicable.

The basis of the net shares acquired for the exercise will be the current FMV, if the exercised option is an NQSO, or the amount of any nominal cash paid (to make up for a difference in the value of the shares exchanged and the exercise price) for the exercise, if the option is an ISO. (See the March-April 1997 issue of *The Corporate Counsel* at pg 6 and myStockOptions.com’s excellent explanation (under Taxes Advanced) of the tax basis of shares acquired on a swap exercise and how Rev. Rul. 80-244 works.)

One advantage to swap transactions is that they are clearly permissible for EOs. Moreover, provided that the shares tendered are not ISO shares or, if originally acquired under an ISO, have been held for the requisite holding period, the tender is not considered a disposition dis-

qualifying or qualifying) of the tendered shares. But, in addition to the practical timing obstacles, there may be other reasons why swap exercises never really became popular, e.g., the requirement to already own company stock presents an obstacle and the taxes due on the exercise present a further obstacle. (See the March-April 1997 issue of *The Corporate Counsel* at pg 6.)

Pyramids. A pyramid exercise is a form of swap exercise that is useful when the employee doesn’t already own a sufficient number of shares to swap for own no shares). The employee in our example would pay \$10 to exercise one share of the 100-share option, then immediately tender that one share (at the current FMV of \$25 per share) to exercise an additional 2.5 shares, then tender those 2.5 shares (having a value of \$62.50) to exercise another 6.25 shares, etc. In practice, all the windfalls happen virtually, so that the net result (for the 60 net shares)

pyramid exercise that with is to either or has to stock that with a net

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or shares of equity, an employee doesn’t pay anything to the company, instead the transaction is fully funded through the appreciation that has accumulated in the stock right. For this reason, pyramid exercises might be preferable over net exercise for ISOs because employees are actually paying for the first shares exercised in the pyramid (and then tendering the acquired shares to purchase the remaining shares in the option), ISO treatment is not in question. The exercise would be considered a disqualifying disposition of the shares tendered back to the company, but because the option retains its ISO status, no withholding would be required (see our May-June 2005 issue at pg 7). (The tax basis complications for pyramids, particularly of ISOs, can be mind-boggling; 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).

The tax withholding could be paid in cash or by withholding shares from those issued to the employee, or via an open market sale by the employee. Of these three alternatives, share withholding is the easiest from an administrative standpoint. Payment in cash (or withholding from the employee's next paycheck) is no more feasible for net exercises, etc. than it is for traditional option exercises. An open market sale is problematic in that there will be a discrepancy between the amount used to compute the taxable gain on exercise and the sale price. One difference between net exercises, etc. and same-day sales is that the taxable gain for a same-day-sale exercise of an NQSO is typically considered to be the difference between the sale price and the upon-exercise price (see the March-April 1992 issue of *The Corporate Counsel* at pg 2); with net exercises, ESOPs, etc., the shares are sold specifically to

Another potential problem with an open market sale to cover the taxes on ESOPs is the deadline for depositing the withholding taxes with the IRS. If the company's withholding liability for all employees in aggregate exceeds \$100,000, the deposit must be made to the IRS by the next business day. For ESOPs, there is an IRS Field Directive that provides that the deposit is considered timely if made within one day of settlement (see our May-June 2003 issue at pg 9). But, as we have noted in recent discussions of restricted stock (see our November-December 2006 issue at pg 2), the language in the directive is specific to NQSOs and it is not clear that the directive can be relied on for other types of arrangements. Thus, for ESOPs (net exercises should be okay), there would be a question as to whether the company may need to deposit the tax withholding with the IRS before the sale covering that withholding is settled.

A Big Administrative Advantage Over Cashless Exercises. Share withholding resolves these issues. In our example, the company would simply hold back an additional 1% share, to cover the

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only the tax until the taxable gain is the FMV (typical price) and the a discrepancy

reducing the service to 15 have estimated financial tax project is not n has already at Security. If

value used to determine the employee's ordinary income. The employee reports this discrepancy as a capital gain or loss on Schedule D.

But this tax treatment may not be as significant a disadvantage as it first appears. Even with a traditional cashless exercise/same-day sale, the employee is still required to file Schedule D and often still has a capital gain or loss to report. Some companies choose to report the spread between the exercise price and the FMV (close or average price) as ordinary income to the employee, creating the same discrepancy between the FMV of the exercised shares and the sale price that you have with net exercises, etc. When the company reports the spread between the exercise price and the sale as ordinary income, the employee reports a capital loss in the amount of the broker's fee. Another disadvantage of selling shares to cover the tax withholding is that it results in the flow of some shares into the market that net exercises, etc. are intended to eliminate.

applicable, shares could be withheld to cover these taxes as well.) There is no flow of shares into the market and the shares applied in the tax withholding are valued at the same FMV used to determine the taxable gain on the exercise, thus the employee has no capital gain or loss to report on the transaction. Moreover, the company avoids the administrative overhead inherent in same-day-sale exercises, e.g., issuing the shares, arranging for the ESOP, etc.; there is no need to comply with Rule 144; and the employee avoids paying a brokerage fee (at least until the remaining shares are sold).

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

6 of non-employee directors, or the company's shareholders, in accordance with Rule 16b-3(d)(1) or (2), the exercise of the share withholding right will be exempt from Section 16(b). Finally, the company is not waiting for funds to cover the withholding before depositing the payments with the IRS, resolving concerns over the timing of the deposit.

The primary disadvantage to share withholding is the company must reimburse the employee from simple into the market should mitigate the relatively big savings and share withholding.

Where taxes will be paid through share withholding, the tax payments must be limited to the statutorily required minimum payment. EASB views shares withheld to cover excess tax payments as a cash payout triggering liability (mark-to-fair value) accounting. This involves the same rounding issues that we have discussed with respect to share withholding on restricted stock (see our November/December 2006 issue at pg. 3).

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 implement net exercises and their alternatives (SSARs, *et al.*): the way ISS, other proxy advisors, and some institutional investors count share usage when evaluating stock plans that are submitted for shareholder approval.

A plan with net exercises or their alternatives would typically provide for "net" counting (see our November/December 2005 issue at pg. 6). For instance, in our 100-share scenario only 60 shares would end up being subtracted from the plan's overall share authorization (or, if shares are withheld to cover taxes, possibly only 45 shares); if a plan provides for gross counting (silence on this issue tends to suggest gross counting), one of the benefits of net exercises and SSARs, etc., is lost.

But, ISS, etc., count the gross number of shares for non-settled options, i.e., they ignore the net counting provision. Moreover, under ISS's "value transferred" approach to assessing

the true cost of the plan, if the plan allows net counting, net settled options are counted as full-value shares (the same as restricted stock), and all shares that could be granted as non-settled options are assumed to be so granted. Little (or potential exercises and SSARs) swaps should be unaffected as the existing shares provide the financing for exercise.

To illustrate ISS's position in our example, 60

(i.e., the net shares). Plan's shares are then in the road consideration, ally, all (or being issued

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for no consideration. Thus, there is "value transfer" of 100 shares. Multiplied by \$10 (assuming that is the market price when ISS is doing its calculation) results in a cost of \$1,000 versus a binomial value/cost of \$30 to \$60 for a 100-share traditional stock option that will be exercised via same-day sale. Paula Todd of Towers Perrin takes issue with ISS's analysis, reasoning that it would be unlikely that the original 100 share option would be recycled through time, even over the full 10-year term of a plan, or result in ISS's worst-case scenario. She points out that it might easily be five or six years before the original option is exercised, thus, the second generation might still be outstanding when the plan expires and grant authorization under the plan terminates. But, the ISS approach to its cost analysis has consistently been "worst case."

Even if you agree with ISS's analysis, we question whether this should really be a deal-breaker for SSARs and their alternatives. The end result of ISS's cost analysis is that they will approve fewer shares for a plan with a net counting provision, not that they won't approve the plan at all. In some cases, a company's share request may easily pass the value transfer test even with a net share counting provision. And, with the constant flow of shares back into the plan, companies shouldn't need as many shares as they would for cashless exercised same-day-sale options. For example, let's say a company typically grants options for 1,000,000 shares per year, the currently outstanding and exercisable options have an average spread of \$10, and the stock is currently trading at \$25 per share. If 1,000,000 of

the outstanding options were exercised via net swap, or pyramid transactions, the shares returning to the plan as a result of those 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 accounting. 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 methods, and company assets and their assets to repurchase market. With this alternative

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net-settled SARs (final Regs. cited that (i) the SAR can never expire, (ii) the SAR never be less than the SAR does

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 (i.e., savings and unauthorized 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).

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 EAC 123 in 2002. During an NASPP webcast in 2006, Valerie Steffen, 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 home here, but SARs enjoy essentially the same exemption from Section 409A/NQDC that NQSOs do. Originally, all SARs would have been subject to section 409(a)

net-settled SARs (final Regs. cited that (i) the SAR can never expire, (ii) the SAR never be less than 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 SARs is also outside the scope of this article. Suffice it to say that net exercises and SARs 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

8 be reported, just as for cashless exercises. It is permissible to include a footnote indicating the net shares actually issued to the executive. 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 under the options (assuming net exercise is required) or SSARs based on the FMV at year-end. Where the cash flow implications of switching to net exercises, etc. are material to the company, discussion may be warranted in the MD&A, to the extent that the switch is material to an understanding of the company's compensation program or there are material tax implications for the particular form of compensation, that disclosure in the CD&A may be necessary.

In the S-K Item 201(d) stock plan table, however, practices differ. While historically some companies have reported the aggregate shares outstanding under their grants, on March 13, 2007, the SEC issued an interpretation permitting companies to

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in case of same-day sale) or for tendered SSARs. When a company's plan allows net exercising, the same consideration applies to the disclosure of the number of shares available for grant under the plan.

In terms of the S-K Item 703 disclosure relating to company purchases of its own stock, swap and pyramid exercises are disclosed as a company purchase, but SAR and net exercises are not (see our March-April 2005 issue at pg. 10).

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

(Model Form No. 109), and withholding shares to pay taxes (Model Form No. 105). In all cases, acquisition of the aggregate number of shares exercised (not just the net shares) is reported in both Tables I and II with a disposition for the shares equivalent to the option price (and any shares tendered to cover taxes, if applicable) in Table I. [Don't forget to make sure that the tax withholding right as well as net exercises have been approved in accordance with Rule 16b-3(a)(1) or (2).] If shares are sold to cover taxes, an additional transaction is necessary.

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 it permits net exercises, SSARs, and pyramid or swap exercises. Many companies have various plans that permit a broad range of grant types and exercise methods; these plans may already allow for SSARs. Likewise, most plans already provide for swap exercises. If so, net and pyramid exercises might also be permissible, unless the plan specifically prohibits tender of shares that have been held for less than six months.

Generally, amending a plan that provides for the grant of traditional stock options to allow for SSARs and net, pyramid, or swap exercises should not require shareholder approval, even under the SRO rules—provided, of course, that the plan itself allows for amendment by the board only. The NYSE considers material revisions to a plan to be those that expand the type of awards available under the plan, increase the shares available under the plan, expand the plan's eligibility criteria, extend the plan, change the method of determining option exercise prices, delete or limit a plan provision prohibiting repricing, or increase the plan's dilution (NYSE FAQ D-1). Removing a requirement that shares tendered to pay for an option exercise be held for six months or adding the ability for employees to

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).

Nasdaq is not quite as clear: here the need for shareholder approval hinges on whether the amendment is material in terms of the benefit provided to participants or the burden on the company (see the January-February 2004 issue of *The Corporate Counsel* at pg 10). We understand, however, from Art Meyer's presentation at the 2007 NASPP Conference, that a strong argument could be made that the amendment is not material.

Amending your plan to allow net counting, however, could be a little more difficult. Here, the amendment would be considered material under both NYSE and Nasdaq listing requirements and would require shareholder approval.

Step 2: Make Critical Plan Design Decisions.

In as much as net exercises, SSARs, etc. deliver the same economic benefit as options with a counters exercise program, they involve most of the same plan design decisions. Where a company already has a well-established option plan and grant guidelines, the same design and grant guidelines can be easily applied to the net exercise or SSAR program. There are, however, a few design aspects that are unique to net exercises, SSARs, etc.

As discussed earlier, the company will need to decide how to pay for the exercise. If the company has a large number of employees, it may be given a choice of how to pay for the exercise: in cash, or by market sale to employees. We don't think it is necessary to provide a choice to employees (and providing a choice only makes communicating the new program to employees that much more complicated). Provided that cash flow is not a concern, our preference is for companies to require share withholding to cover taxes. And, since there will be no market sale involved, don't forget to carefully parse the plan's definition of FVW for purposes of determining the amount of taxable

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 that the current FVW divides evenly into either the exercise price or the spread at exercise, resulting in a fractional share that must be dealt with. For net exercises and SSARs, the fraction is typically paid out in cash (although some service providers may now support fractional share issuances, enabling the fraction to be issued in stock); for swap and pyramid exercises, the number of shares to be tendered is typically rounded down and employees must make up the difference in cash.

Step 3: Consider International Employees.

Companies with employees outside the United States will also have to evaluate the new program in each country where their stock plan participants reside. The same tax, securities law, foreign exchange controls, data privacy laws and labor laws that apply to stock options will most likely be an issue for SSARs as well (although the laws may not apply in exactly the same manner as they do to stock options). Moreover, regulators in many countries are not familiar with the concept of SSARs, thus it may be easier, internationally to stick with stock options and simply offer the price net exercise.

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 be necessary to file a new Form S-8 for the plan unless shares are added to the plan at the same time as a net counting provision is

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The Corporate Executive
for the critical days ahead.**

added (see our November-December 2005 issue at pg 4). But if you cover net exercise methods, in order to file prospectus, you will need to file prospectus (see our November-December 1996 issue at pg 4) and Form S-8 prospectus do not have to be filed with the SEC.

It also may be necessary to draft new agreements to cover the new types of grants or exercise methods. (See sample agreements for options allowing net exercises and for SSARs on Naspc.com.) Where grants will be made to officers and directors, the new agreements will

10 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? Those can typically be amended to allow/require net exercises, swap or pyramid exercise or to convert to SSARs. Where the plan already allows these transactions or rights, then amending the options should not require shareholder approval. Companies should verify that the amendment is permissible under the plan and applicable law.

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If the original SSARs (or net exercise) don't disqualify the options from tax treatment (and, under the terms of some plans, would therefore require employee consent). Even amending ISOs to allow swap or pyramid exercises could be a problem; any amendment that provides an additional benefit to the employee is considered a cancellation and regrant of an ISO. If conducted at a time when the option is in-the-money, the option would be viewed as having a discounted price, which is prohibited for ISOs under Section 424. Even if the option is out-of-the-money at the time of the amendment, it could be necessary to verify that the new grant complies with all the requirements for ISOs, including the \$100,000 limitation.

Surprisingly, however, the amendment would not be a problem under Section 409A. Reg. §1.409A-1(a)(5)(i)(B) defines modification for purposes of 409A as a change in terms that provides the employee with a reduction in price, an additional deferral feature, or an extension/renewal of the right. Adding a new exercise method, eliminating existing exercise methods, or converting the option to an SAR implicates none of these notions and, as we've already established, SSARs and their alternatives are permissible under §409A.

Ditto for Section 162(m) and Section 16—no problems there. Art Meyers tells us that in SFL, no action letter *Ware and Fiedlermich* (January 10, 1992), the Staff opined that adding a cash-

less exercise feature to an option doesn't constitute a cancellation and regrant of an option for purposes of Section 16. Thus, by analogy, adding a net, pyramid or swap exercise feature also wouldn't be a cancellation and regrant. Likewise, converting options to SSARs shouldn't be considered a cancellation and regrant for Section 16 purposes, since the conversion doesn't change the economic of the arrangement for the insider. (Again, don't overlook approving the exercise and vesting features in accordance with Rule 16b-3(d)(1) or (2).) Art also tells us that there is a 2005 IRS letter ruling addressing a similar modification and providing that it did not constitute a cancellation and regrant of the option.

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can raise the stock price prior to the modification—not their fair value when originally granted, would be treated as additional compensation cost. From a practical standpoint however, it is unlikely there would be any increase in fair value. The only factor that might be impacted for valuation purposes would be the expected life of the rights, the exercise price, market value, expected volatility, expected dividend yield and interest rate would all remain unchanged by the change. Thus, unless the amendment is expected to cause employees to delay exercise (which would increase the expected life of the rights, and consequently, their fair value), it is unlikely that there would be any difference in fair value either before or after the amendment and no additional compensation cost.

Step 6: Educate Employees and Reap Benefits. If adding net exercises, pyramid or swap or an SAR component to an outstanding option is simply an additional right that can't adversely affect the employee, consent/agreement should not be required. Thus, unless the option is an ISO (as we've discussed, a material modification of an in-the-money option would exclude ISO treatment), consent shouldn't be required here. Hence, no worry about the federal tender offer rules.

But, of course, even where consent isn't required, it will be necessary to educate employees on the new exercise method. While employees

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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The NASPP invites you to join us for our 16th Annual Conference from October 21-24 in New Orleans. Building on our 16-year history as the premier event for stock plan professionals, the NASPP Annual Conference brings together top industry luminaries to deliver fresh perspectives and cutting-edge guidance on the latest issues in executive and stock compensation. This year's Conference includes a full week of critical and timely sessions.

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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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