The NASPP Advisor

Vol. 14, No. 2 | Practical Guidance for NASPP Members | March-April 2006

Top Ten List: Things You Can Do Under FAS 123(R) That You Couldn't Do Under APB 25

All calendar-year companies had to adopt FAS 123(R) by January 1, 2006. In recognition of this landmark event, our top ten list for this issue describes ten actions companies can take under 123(R) that they were discouraged from taking under APB Opinion No. 25.

1. **Grant stock-settled stock appreciation rights.** Stock appreciation rights offer the same economic benefits as stock options but result in the issuance of fewer shares, reducing plan dilution and mitigating the need for costly repurchase programs. Now, under 123(R), stock-settled SARs receive the same accounting treatment as stock options (under APB 25, these arrangements were subject to costly variable-plan accounting), paving the way for companies to begin granting them (and converting existing options to them as well). Listen to the archive of the NASPP's April 18 webcast, *The New Cashless Exercise: Stock-Settled SARs*, for the low-down on stock-settled SARs.

2. **Offer a pyramid scheme.** Well, not a pyramid scheme per se, but pyramid exercises, net exercises, and immaculate exercises, all of which enable employees to tender their exercised shares back to the company in payment of their option price and taxes, receive much more favorable treatment under 123(R). If you haven't looked at these transactions in the past 30 years because of APB 25, now is the time to re-examine them. The NASPP's webcast, *The New Cashless Exercise: Stock-Settled SARs*, features one company that has already amended its plans to allow pyramid exercises.

3. **Eliminate your same-day sale program.** With the advent of stock-settled SARs and new alternatives for exercising traditional stock options, you may find that your same-day sale program is no longer necessary. Without this constant flow of shares into the market, your stock plan better achieves it's objective of delivering stock to employees and may be more palatable to shareholders (not to mention eliminating the myriad of issues that apply to insider sales).

4. **Implement required holding periods.** Now that executives no longer need to sell shares or come up with cash out of pocket to fund option exercises, it is viable to implement required holding periods for stock acquired upon exercise. Many companies have implemented hold-til-retirement requirements for their top executives, sending a strong message to shareholders that they are in for the long-term.

5. **Grant performance-based options and awards.** Long the scourge of stock plans under APB 25, performance-based grants are an exciting new opportunity under 123(R). These endlessly flexible vehicles can help maximize the cost-benefit of your stock plan, achieve company goals, and make the plan more palatable to shareholders. Read the NASPP Document Library articles "FAS 123R's Golden Opportunity: Performance-Based Equity Compensation Comes Into Its Own" and "Get Better Results from Long-term Incentive Pay" for more information on performance-based awards.

6. **Eliminate performance-accelerated grants.** Because true performance-based grants were subject to variable-plan accounting under APB 25, many companies granted awards where vesting was accelerated upon the achievement of performance goals but that vested anyway after a specified period of time (usually five years) if the targets were not achieved. Under 123(R), there is no need for this fail-safe vesting event (which employees often focus on to the exclusion of their performance targets). Companies can now grant awards that are subject to forfeiture when performance targets aren't met, refocusing employees' efforts towards meeting those targets rather than just waiting out their vesting periods.

7. **Implement a value-for-value option repricing.** 123(R) provides a great opportunity to finally do something about all those underwater options on a cost-neutral basis. With a value-for-value repricing, employees exchange their underwater options for new at-market options. The number of shares in the new options is reduced so that the fair value of the replacement options is equal

to the fair value of the underwater options, eliminating any incremental expense the company would recognize for the transaction.

8. **Require employees to tender underwater options in exchange for annual grants.** Another possibility for underwater options under 123(R) is to require employees to tender them in exchange for their annual grants (that they would have otherwise received anyway). This reduces the number of options outstanding under the plan, increases the shares available for grant, and reduces the expense for the annual grants (by the current fair value of the underwater options).

† Looking for more information on tips 7 and 8? The January-February 2006 issue of *The Corporate Executive* covers both of these programs in-depth. Since last year, *The Corporate Executive* has been running a series of extensive articles on 123(R) implementation issues and opportunities; if you don't subscribe to this esteemed publication, now is a great time to start. NASPP corporate members receive a discount on multi-copy subscriptions, contact naspp@naspp.com for more information.

9. **Grant full value awards.** Many companies shied away from full value awards under APB 25 because they resulted in expense, whereas at-market stock options did not result in any expense. Since both arrangements result in expense under 123(R), companies are now free to grant full value awards where they make sense. Consider this decision carefully, however. Shareholders are likely to be less enamored of full value awards that vest on mere continued service and appreciation-only awards still make sense for many companies. Those companies that do grant full value awards should consider tips 5 and 6 above, especially for grants to executives.

10. **Adopt a portfolio approach to stock compensation.** With all forms of stock compensation on an equal footing in terms of expense, companies are no longer limited to just one type of arrangement. Many companies may find that it makes sense to grant multiple types of awards; some companies are even allowing employees to choose the types of awards they want.

Bonus List: Three Things You Can Do Under 123(R) But That Might Be Problematic Under Section 409A

1. **Extend option expiration or post-termination grace periods.** Under APB 25, extending the time in which an in-the-money option could be exercised resulted in additional expense equal to the current intrinsic value of the option. While this type of modification can still result in an incremental charge under 123(R), that charge is equal to the increase in fair value resulting from the new term (typically less than the intrinsic value and, in some cases, immaterial). But, watch out: under the proposed §409A regulations, extending the expiration or post-termination grace period could cause the option to be retroactively treated as deferred compensation.

2. **Accelerate vesting upon termination.** Under APB 25, accelerating vesting upon termination also resulted in an expense equal to the intrinsic value of the portion of the option or award being accelerated. Under 123(R), the incremental cost for this modification is equal only to the increase in fair value of the award. In many cases, there may be no incremental cost or the cost may be immaterial. Where vesting is accelerated for key employees, however, it may be necessary to comply with the requirements for severance payments under §409A.

3. **Grant discounted stock options.** Discounted stock options were out of favor under APB 25 for the same reasons that companies avoided full value awards. Under 123(R), the increase in fair value resulting from the discount is likely to be less than the amount of the discount, making below-market options more cost-effective than at-market options. Unfortunately, §409A treats discounted options as deferred compensation; to avoid stiff tax penalties, these options must be subject to a fixed payout schedule.

Visit the NASPP's Deferred Compensation Legislation portal for more information on how Section 409A applies to stock compensation.

Additional Resources for NASPP Members

SSARs and Pyramid/Net Exercises

- *The New Cashless Exercise: Stock-Settled SARs*, NASPP Webcast, April 18, 2006 (http://www.naspp.com/webcast/2006_04_18.htm)
- "The New Cashless Exercise—Stock-Settled SARs," Arthur Meyers, Seyfarth Shaw LLP, November 3, 2005 (http://www.naspp.com/members/dlib/files/N503.PDF)
- NASPP portal on Stock-Settled Stock Appreciation Rights (http://www.naspp.com/members/Portal/SSARs.htm)

Performance-Based Grants

- "FAS 123R's Golden Opportunity: Performance-Based Equity Compensation Comes Into Its Own," by Deloitte, February 2006 (http://www.naspp.com/members/dlib/access.asp?ID=499)
- "Get Better Results from Long-term Incentive Pay," by Richard Ericson, Towers Perrin, published in *Financial Executive*, November 2005 (http://www.naspp.com/members/dlib/files/N500.PDF)

Option Repricing

- "How About Cancelling Underwater Options Incident to 2006 Grants," *The Corporate Executive*, January-February 2006 (available to *The Corporate Executive* subscribers only)

Treatment of Stock Compensation under Section 409A

- "Proposed Section 409A Regulations Affect Equity Compensation," by DLA Piper Rudnick Gray Cary, November 22, 2005 (http://www.naspp.com/members/memos/DLA/11_22_05_deferred.pdf)
- "New Rules for Equity Compensation," by Covington & Burling, October 31, 2005 (http://www.naspp.com/Members/Memos/CovingtonBurling/10_31_05_equity.pdf)
- "Proposed Regulations under Section 409A–Important Issues for Stock Options," by Latham & Watkins, November 18, 2005 (http://www.naspp.com/members/memos/Latham/11_18_05_deferred.pdf)
- "Stock Options and SARs Under the New 409A Regime," by Watson Wyatt, November 2005 (http://www.naspp.com/members/memos/Watson/11_05_deferred.pdf)