


3<sup>rd</sup> Annual CEP Symposium Santa Clara University

## Certified Equity Professional Institute

**Top Ten Things You Can Do Under 123(R) That You Couldn't Do Before!**

Barbara Baksa, CEP  
National Association of Stock Plan Professionals

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### Top Ten Things You Can Do Under 123(R) That You Couldn't Do Before!

- Is there a silver lining to 123(R)?
  - Even playing field for all forms of stock-based compensation
  - Fixed accounting for performance-based arrangements
  - Fixed accounting for modifications



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### #1 – Grant Stock Settled SARs

- Stock-Settled Stock Appreciation Rights
  - Right to appreciation on stock realized from grant to exercise
  - Result in fewer shares issued than traditional stock options
  - Same treatment as stock options under 123(R)

	NQSO	SSAR
Shares Granted	1,000	1,000
Price	\$10	\$10
Market Value	\$25	\$25
Shares Issued	1,000	600
Taxable Income/Co. Deduction	\$15,000	\$15,000

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### #1 – Grant Stock Settled SARs

- **Advantages**
  - Reduce number of shares issued for option exercises
  - Reduce open market sales
    - Consider implementing holding period on net shares issued
  - Eliminate/reduce need for repurchase programs
  - Unissued shares can increase plan reserve
    - Will reduce number of shares ISS will approve for the plan
      - But with additional shares, share allocations may not be needed as early

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### #1 – Grant Stock Settled SARs

- **Challenges**
  - Tax withholding still required at exercise
    - If shares are used to cover withholding, results in cash outflow for company
    - Funding with open market sale has its own issues
      - Results in an open market sale, something we hoped to avoid
      - Discrepancy between sale price and market value can produce tax loss for employee
  - Many service providers are not yet equipped for SSARs

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### #2 – Offer a Pyramid Scheme

- **Pyramid exercises**
  - A succession of progressively increasing swap exercises
  - The optionee pays cash to exercise one share, then tenders the share to exercise additional shares, then tenders those shares to exercise additional shares
- **Net or immaculate exercises**
  - The optionee tenders a portion of the shares he is exercising to cover the cost of his exercise
- **Advantages and challenges for both are similar to SSARs**

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### #4 – Require Holding Periods

- **Require executives to hold net shares acquired upon exercise**
  - Much more viable now that executives do not need to sell shares or pay cash to exercise options
  - Holding periods could be for one year, several years, or until retirement
  - Sends a strong message to shareholders
    - Particularly relevant in today's critical environment

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### #5 – Grant Performance-Based Options and Awards

- **Performance-based arrangements receive fixed accounting treatment under 123(R)**
  - **Non-market conditions**
    - Goals that are not related to stock price, e.g., revenue, EPS, departmental or individual targets
    - Essentially the same treatment as service-based grants
  - **Market conditions**
    - Goals related to stock price, e.g., price targets or total shareholder return
    - Fair value is reduced for market conditions (no reversal of expense for forfeitures)
- **Performance goals can be company-wide, departmental, or individual**
  - Endless flexibility in how arrangements can be structured
  - Ensure that company has realized a measurable benefit in exchange for expense associated with the grant

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### #5 – Grant Performance-Based Options and Awards

- **Challenges**
  - Determining the right goals is tricky
    - Integration with bonus plan and other long-term incentives
    - Stock options already are inherently performance based
      - Do underwater options still motivate performance?
    - Line of sight considerations
      - Do employees feel they have ability to influence whether targets are met
  - Treatment under 123(R) can be more complex than it first appears
    - Determination of service period can vary depending on targets
    - Market-related goals require a sophisticated pricing model
    - FIN 28 attribution required for awards with multiple targets
    - Grant date doesn't occur until targets have been defined
    - Adjustments to forfeiture estimate/service period for changes in likelihood that targets will be met
    - Combination of market and non-market related goals

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**#7 and #8 – Address Underwater Options**

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- #7—Value-for-value exchange
  - New grants are for fewer shares so that fair value of the new options does not exceed fair value of the underwater options.
  - In our example, if the new options were for two-thirds the number of shares in the old options, there would be no incremental cost associated with the repricing:

**Example**

Current fair value of underwater options*:	\$10 x 1,000,000 shares =	\$10,000,000
Fair value of new options*:	\$15 x 666,666 shares =	\$10,000,000
Incremental cost of the repricing:		\$ 0

\* Fair value calculated using the Black-Scholes model assuming an expected term of 5 years, 5% interest rate, 50% volatility, and no dividend yield.

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**#7 and #8 – Address Underwater Options**

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- #8—Require employees to tender underwater options to receive annual grants
  - Annual grants are issued as normal
    - Type, shares, pricing, vesting per standard grant guidelines
    - Underwater options are cancelled
      - Reduces expense associated with annual grants

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**#7 and #8 – Address Underwater Options**

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- Advantages
  - Reduces plan overhang
  - Provides additional shares for future grants
  - Eliminates options that may no longer retain or motivate employees
- Challenges
  - Tender offer rules still apply
  - Nasdaq/NYSE listing requirements still apply
  - 123(R) treatment is more complex than described here, especially with regards to forfeitures—consult your accounting advisors!

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**#9—Grant Full Value Awards**

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- Full value awards
  - Restricted stock awards and units issued at no cost
  - Avoided under APB 25 due to compensation expense
  - Advantages
    - Never underwater
    - Lower risk profile and higher perceived value by employees
      - Grants can be for (sometimes dramatically) fewer shares
      - With reduced number of shares, fair value of awards might be lower than fair value of comparable options
    - Valuation for 123(R) purposes is simpler
      - Fair value is generally equal to market value of underlying stock
        - Fair value of awards that vest based on market conditions must be calculated using an option pricing model

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**#9—Grant Full Value Awards**

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- Full value awards
  - Challenges
    - Shareholder backlash
    - Stock options may deliver more value to employees in high-growth companies
    - Lots of new administrative challenges
      - Tax withholding
      - Dividends

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**#10—Adopt a Portfolio Approach to Stock Compensation**

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- Consider offering a mix of awards to employees
  - Appreciation-only awards
  - Full value awards
  - Performance-based arrangements
- Allow employees to choose their own portfolio

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### Top Three Things You Can Do Under 123(R) (That Might be a Problem Under 409A)

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### #1—Extend Option Expiration or Post-Termination Grace Periods

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- **Extending option expiration or post-termination grace periods**
  - Resulted in additional expense under APB 25 equal to current intrinsic value of the option
  - Treated as any other modification under 123(R)
    - Incremental cost is equal to value of modified award less value of original award just prior to the modification
    - Short-term extensions are not likely to result in a material amount of additional cost
  - Under proposed 409A regs, however...
    - Extension is viewed as an additional deferral feature that existed at the time of grant, causing the option to retroactively become subject to 409A penalties
    - Exception where expiration is not extended beyond the later of:
      - The end of the calendar year option originally would have expired in
      - 15<sup>th</sup> day of the 3<sup>rd</sup> month after original expiration date
  - Other considerations, such as disqualification of ISO status, still apply

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### #2—Acceleration of Vesting

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- **Acceleration of vesting**
  - Resulted in additional expense under APB 25 equal to current intrinsic value of the shares subject to acceleration
  - Treated as any other modification under 123(R)
    - Incremental cost is equal to value of modified award less value of original award just prior to the modification
  - Under proposed 409A regs, however...
    - For awards that are subject to 409A, such as restricted stock units, acceleration may be prohibited
    - Acceleration is not considered a modification of an option and therefore does not cause an option to become subject to 409A

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### #3—Grant Discounted Options

- Discounted options
  - Avoided under APB 25 due to compensation expense
  - Can be cost-effective under 123(R)
    - Economic value of discount to employee is usually greater than increased cost to company
      - Fair value of at-the-money option granted when market value is \$50 per share is \$25 per share\*
      - Fair value of \$40 per share option granted when the market value is \$50 per share is \$28 per share\*
      - \$10 per share of economic value delivered to employee but company's cost increases by only \$3 per share
  - Alas, under 409A, however...
    - Discounted options are viewed as a form of deferred compensation
    - Must be subject to a fixed exercise or payout schedule to avoid penalties

\* Calculated using the Black-Scholes model assuming a 5-year expected term, 50% volatility, 5% interest rate, and no dividends.

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### Top Ten Things You Can Do Under 123(R) That You Couldn't Do Before!

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