Stock & Option Solutions

Cooley GODWARD KRONISH LLP

equitymethods smarter compliance

Option Exchanges: The Good, the Bad, & the Ugly

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Webinar Materials

http://www.sos-team.com/PDFS/Option_Exchanges.pdf

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Problem: Subjective vs Objective Values

Your house as seen by…

Yourself…

Your Lender…

Your Buyer…

Your Appraiser…

Your Tax Assessor…

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Subjective vs Objective Values

Objective versus subjective award fair value

- Objective: FAS 123R value under FAS 123R
- Subjective: Measures employee's assessment of award value
  - Certainty equivalent: amount of cash you'd take for option today
  - Lower than objective value due to employee risk aversion, poor wealth diversification, etc.

Subjective-objective value ratio

- Wedge between subjective and objective value represents some efficiency drain from options
- Other positive factors still make options a solid form of compensation
- Watch the wedge and how it changes:
  - As an option falls underwater, the wedge increases
  - Initially an efficient and useful compensation instrument may have little to no incentive or retentive impact as share prices decline

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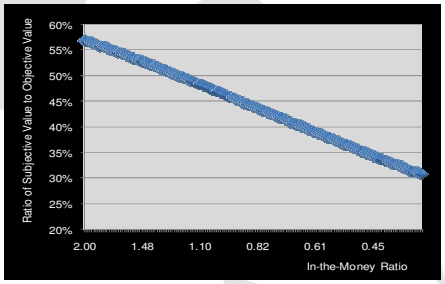
Subjective vs Objective Values

A "double-whammy" effect on employee when the share price declines

1) Option is overall less valuable because the share price has declined; AND
2) Disproportionally large impact on the employee's subjective value of the award.

Plot of subjective value as a fraction of objective value across in-the-money levels:



Developed using standard assumptions per Jonathan Ingersoll, "The Subjective and Objective Evaluation of Incentive Stock Options," *Journal of Business*, Vol. 79, No. 2, March 2006.

Objective and subjective fair values across in-the-money levels:

Current Stock Price	In-the-Money	Objective Value	Subjective Value
$62.66	1.25	$37.06	$18.62
$49.84	1.00	$25.96	$12.13
$37.72	0.75	$16.26	$6.89
$25.08	0.50	$7.58	$2.73
$12.63	0.25	$0.42	$0.01

Grant price = $50, volatility = 30%, dividend yield = 0%, risk-free rate = 5%

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Goals of Exchanges

How to reprice options (or exchange) while

- Keeping shareholders happy
- Keeping ISS/Institutional Shareholders happy
- Keeping executives happy
- Making employees happy again!
- Meeting all the regulatory requirements!
- Keeping administration manageable!

Structure an exchange that is beneficial to all stakeholders:

- The Company
- Employees
- Shareholders

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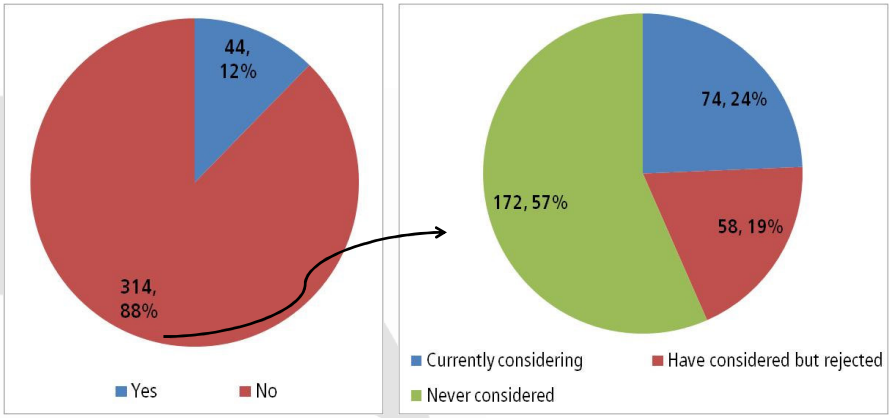
Who's Exchanging?



N = 358

* From Equity Methods' Underwater Options Survey

q1, q29

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Exchange Process Overview

Assess/ Prepare	Board Approval	Shareholder Approval	Tender Offer	Implement
• Know shareholders • Review plan • How far/long underwater? • Tax expense • Exchange Type • Potential payout • Accounting impact • Draft materials • Timing • Assess system capabilities	• BOD presentation & approval • Comp committee • Logistics • Define preliminary exchange rate	• Shareholder approval (Not always required) • Proxy solicitation	• Define final exchange rate • Begin TO (open for 20 days) • Clear & careful employee communication • Understand what is being said – be consistent • Close TO	• Compute fair value on date of modification • Test for incremental cost • Implement exchange • Adjust data and financial reporting process

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Know Your Shareholders

Who owns your stock?

- Majority shareholder – consult with them
- Institutional shareholders
  - Who do they listen to?
    - Proxy advisory firms
      - » ISS
      - » Glass Lewis

Get proxy solicitor involved early

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Questions About Your Plan(s)

Is shareholder approval required for an exchange?

Are cancelled shares returned to the plan?

- Depends on terms of the plan
  - Are "cancelled" shares returned to reserve?
- May be worded in proxy proposal that shares will not be returned to garner ISS recommendation

What else does your plan say about exchanges?

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Questions to Answer

Goals
- Retention / Morale
- Share conservation

How far underwater are your options?

How long have they been underwater?

How long until expiration?

Has turnover increased?

*See appendix for examples of analysis

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Tax Accounting Impact

Deferred Tax Asset booked as expense accrued
- Anticipates future tax deduction at exercise
- Recognized Expense * Corporate Tax Rate

Tax deduction never occurs (expires underwater)
- DTA reversed, offsetting entry reduces Additional Paid in Capital (APIC) OR increases Tax Expense

Assess impact of grants expiring
- Multiply fair value * tax rate
- Compare to existing APIC Pool to assess hit to expense

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Strike Price Hurdle

Including options that are only slightly out-of-the-money

- Negative message to shareholders and the market in general

Statistic	Value
Average	0.58
Median	0.62
Minimum	0.20
Maximum	1.00

* From Equity Methods' Underwater Options Survey

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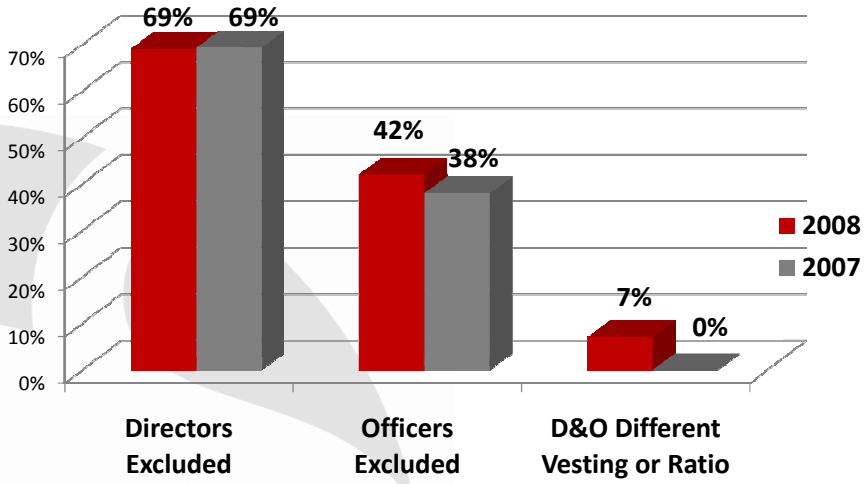
Director & Officer Treatment



* Cooley Research Data up through December 31, 2008.

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What Type of Exchange?

Option-for-Option

Option-for-RS/RSU

Option-for-Cash

Options for Options OR RSUs

- Participant choice?

Value-for-Value

Set Ratio

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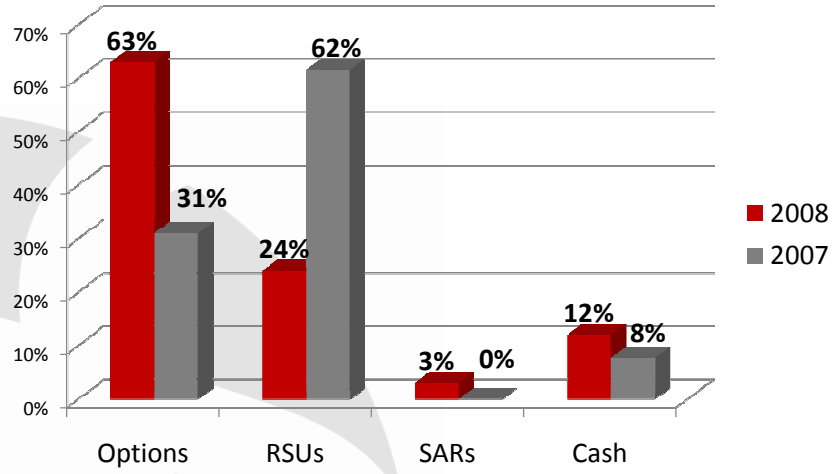
Options Exchanged For:



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Options for Options

Advantages	Disadvantages

• Ease of communication
• Reduce burn rate, overhang & dilution
• Some plans allow w/o shareholder approval
  • Becoming much less common
• Retain the leverage of an option
• Correct subjective-objective value differential
	• Negative employee reaction:
	  • Employee skepticism toward options if share price decline extended
	• New options may also fall underwater
	• Many systems cannot support, ongoing accrual must be done manually

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Options for RS/RSUs

Advantages	Disadvantages

• Can't fall underwater
  • Less volatile form of compensation
• Rebalances employee portfolio
• Larger reduction in overhang, burn rate & dilution
  • Fungible share counting?
• Further reduce dilution if shares withheld for taxes
• Correct the subjective-objective value differential
	• RS/RSUs
	  • No cash inflow for option price
	  • Fixed taxable event
	• Employee upside reduced by fewer shares issued – "less leverage"
	• Some plans may not allow without shareholder approval
	• Many systems cannot support, ongoing accrual must be done manually

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Options for Cash

Advantages	Disadvantages
• Biggest reduction to overhang, burn rate & dilution • No more underwater options • Immediate value to participants (when no vesting) • Correct subjective-objective value differential • Accelerates expense into current period	• Company cash outlay • No cash inflow for price • No leverage (stock growth) • Differences in cost of equity vs. cost of cash (perceived and real) • No alignment of emp & s/h interests • No retention & attraction features (w/o vesting) • Vesting may cause issues with "prompt payment" for SEC • Fixed taxable event • Many systems cannot support • Potential "all holders / best price" issues • Accelerates expense into current period

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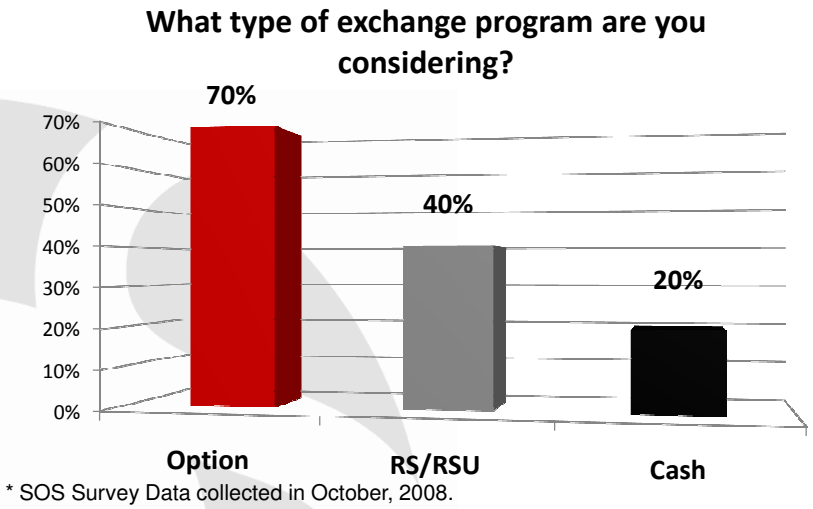
Type of Exchange



* SOS Survey Data collected in October, 2008.

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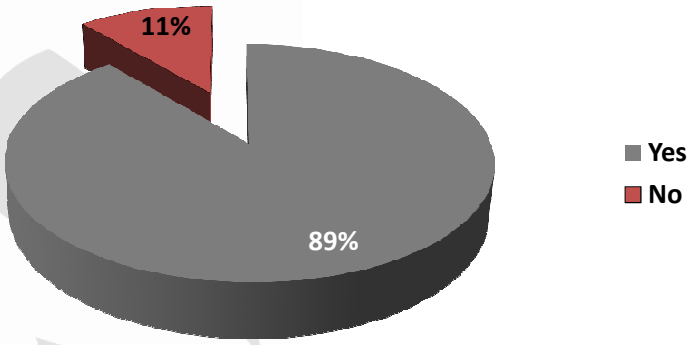
Considering Value-for-Value?

Are you considering a value-for-value exchange?
(9 responses)



* SOS Survey Data collected in October, 2008.

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Other Design Considerations:

Replacement Grant Vesting Period

- No change
- Reset
- Minimum Period
- Different treatment for vested vs. unvested options

Replacement Option Term

- No change
- Reset
- Reduce

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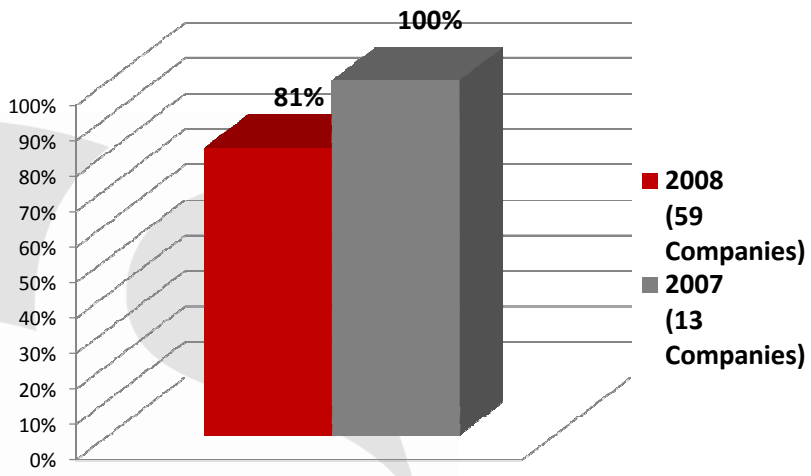
Reset Vesting Schedule



* Cooley Research Data up through December 31, 2008.

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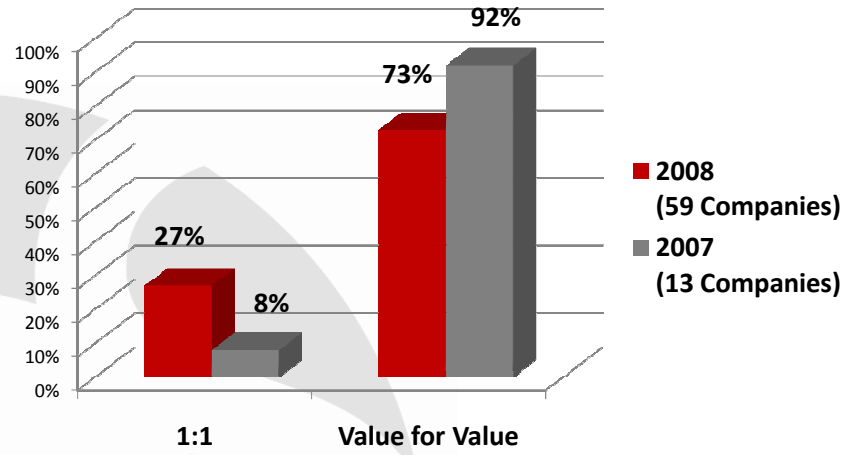
Exchange Ratio



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Improve Perception

Retire shares instead of returning to plan

- Permanently impacts dilution
- Prevents use for executive/board grants
- Retire SOME of the shares

OR… impose limitations on use of shares returned to the plan?

Seek shareholder approval even if plan permits action without approval

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Accounting

FAS 123R

- 6 month + 1 day delay **no longer required** – no variable accounting
- Continue to account for original award, plus account for "incremental cost" of replacement award
  - Incremental cost = excess of fair value of new award over current fair value of original award
  - No negative incremental cost
- Guidance on computing expected term for exchanged option not always applied correctly
  - How do you value it?

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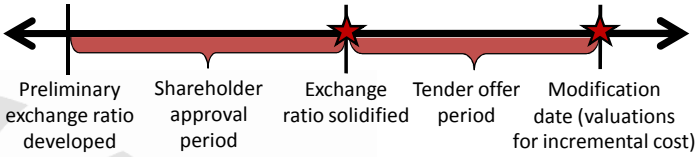
Accounting: Value-for-Value

Two measures of value:



Exchange Ratio Valuation	<	Modification-Date Valuation	=	Negative (Zero) Incremental Expense
Exchange Ratio Valuation	>	Modification-Date Valuation	=	Positive Incremental Expense

Why might values be different?

- Changes in stock price
- Discrepancies in estimation method of each fair value
- Changes in valuation assumptions (volatility, interest rate, etc.)

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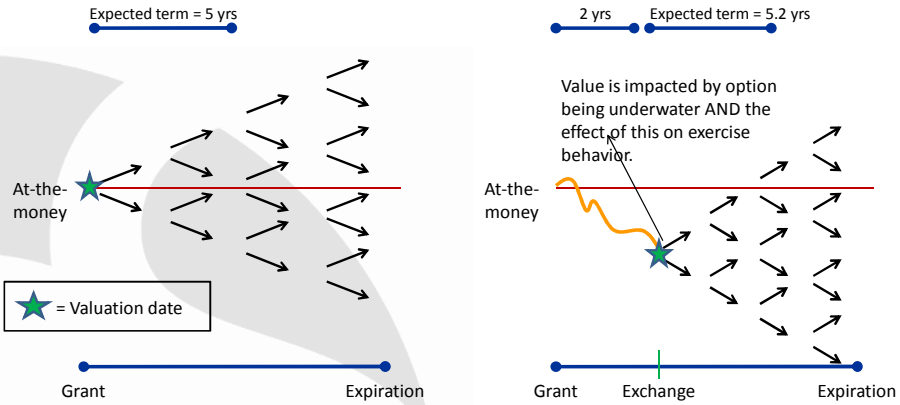
Estimating Expected Term

Valuation of partially and/or fully vested non-at-the-money grants



Best practice: Use lattice model to model expected exercise behavior

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Accounting: Unintended Incremental

What about remaining contractual term?

- Results in a "maximum value" not a "fair value."
- See Paragraphs A3, A18, and A26 of FAS 123R.
- Amplified in the context of underwater options.

Grant ID (A)	Grant Date (B)	Grant Date Stock Price (C)	Options Outstanding (D)	Exchange Ratio Date Stock Price (E)	Exchange Ratio Fair Value (F)	Exchange Ratio (G) G = E / F	Mod. Date Stock Price (H)	Mod. Date Fair Value (I)	Mod. Date Ratio (J) J = H / I	RSUs Exchanged for Options (K) K = D / G	Before Value (L) L = D * I	After Value (M) M = K * H
ABC1	8/20/03	$20.71	2,500	$5.27	$1.04	5.07	$5.55	$0.72	7.71	493	$1,800.00	$2,738.14
ABC2	8/20/03	$20.71	2,000	$5.27	$1.04	5.07	$5.55	$0.72	7.71	395	$1,440.00	$2,190.51
ABC3	6/11/04	$20.25	750	$5.27	$1.09	4.83	$5.55	$0.69	8.04	155	$517.50	$860.93

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Accounting: Bands / Groups for Ratio

Valuing large quantities of options, all of which have potentially different terms and circumstances.

Grant	Grant Date	Strike Price	Current Price	Current Date	In-the-Money	Remaining Term
G100	08/15/1999	$8.25	$7.82	10/25/2008	0.95	.8 years
G101	02/05/2000	$9.17	$7.82	10/25/2008	0.85	1.28 years
G102	06/15/2000	$11.98	$7.82	10/25/2008	0.65	1.64 years
G103	11/03/2001	$12.02	$7.82	10/25/2008	0.65	3.02 years
⋮	…					
G895	09/18/2007	$64.39	$7.82	10/25/2008	0.12	8.9 years

Group	Strike Price Range	Fair Value
1	$8.25 - $12.00	$4.76
2	$12.01 - $18.00	$2.91
⋮	⋮	⋮
10	$58.00 - $64.39	$0.28

Please note: groups may need to be developed also according to the grant dates and not only the strike prices.

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Accounting: Accrual

Option-for-Option or Option-for-RSU

- Accrual
  - Accrual of exchanged grant continues over original vest schedule
    - Or unamortized accrued over new service period (policy decision)
  - Accrual of incremental expense (if any) over new vest schedule
  - Many systems cannot support

Option-for-Cash

- Incremental expense = cash outlay for participant minus current market value of award cancelled
- No accrual over service period, immediate hit
  - Except … if you pay out cash that "vests"
  - Accelerates expense for options into current period
  - "Rip the band-aid off"?

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Accounting: Hidden Floor Provision

Extending vesting schedule can increase retention

- If vested, new grant exchanged is "live ammo"
  - Extending the vesting schedule can foster retention
- Still a value-for-value exchange
  - After Value does not depend on structure of vesting schedule

Extending the vesting schedule may create negative incremental cost

- For example:
  - 100 options valued at $5 exchanged for 50 RSUs valued at $10
  - Grant-date fair value of options was $20
  - Original vesting schedule is 4 years (cliff)
  - RSUs vest one year after modification

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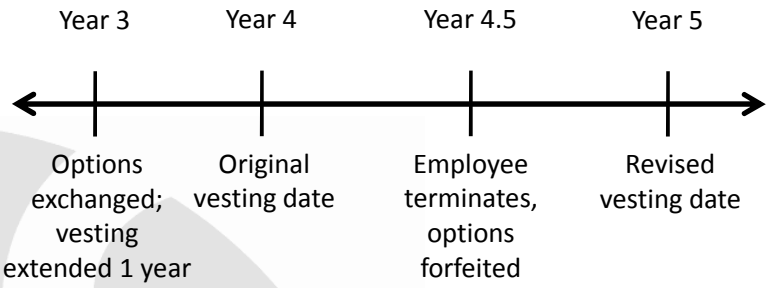
Accounting: Hidden Floor Provision



$1,500 expense recognized to date (¾ * $20 * 100)

If amortizing on modified vesting schedule:

$125 remaining expense. Forfeit $1,875 recognized expense.

Wrong: grant-date fair value of awards has already been earned under original vesting terms.

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Accounting: Tax Accounting

Option-for-Option or Option-for-RSU

- Entire DTA from exchanged grant is "carried forward" to new grant
- Trued up to Actual Tax Deduction at time of exercise or cancellation/expiration of new grant
- Many systems cannot support

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Tax Issues

Incentive Stock Option ("ISO") rules

- $100,000 limit for year of repricing includes canceled options which would have vested in that year
- May result in loss of ISO status for some repriced options

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Securities Issues

Section 3(a)(9) of Securities Act

- Exempts securities exchanged by the issuer with existing security holders where no commissions or other remuneration is paid

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Stock Exchange Rules

Nasdaq/NYSE:

- Need shareholder approval for repricings unless plan specifically permits
- OK to purchase underwater options for a cash payment unless plan prohibits (Nasdaq)

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Riskmetrics/ISS

ISS Governance Guidelines to Secure Shareholder Approval for Exchange:
http://www.riskmetrics.com/policy/2008/policy_information#us

- Case-by-Case policy taking into consideration:
  - **Historic trading patterns:**
    - Stock price not so volatile that options likely to be in-the-money over near term
    - At a minimum, decline should not have happened within past year
  - **Rationale**:
    - Was the stock price decline beyond management's control?
  - **Eligible options:**
    - Cancel only options with strike prices > 52-week high
  - **Value-for-value exchange?**

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Riskmetrics/ISS

Case-by-Case policy taking into consideration:

- **Share replenishment and burn:**
  - Are surrendered stock options added back to the plan reserve?
  - If so, how does that impact the burn rate?
- **Vesting:**
  - Is the new award subject to vesting?
- **Term of replacement option:**
  - The term should remain the same as that of the replaced option (no additional time to exercise)
- **Exercise price:**
  - Should be set at fair market or a premium to market
- **Participation:**
  - Exclude executive officers and directors

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Riskmetrics/ISS Policies

Equity Plans:

- Recommends vote AGAINST equity plans
  - That permit repricing without prior s/h approval,
  - Even if the cost of the plan is reasonable

Compensation Committee:

- Recommend vote AGAINST or WITHHOLD of comp committee
  - Who approved/implemented repricing w/o s/h approval
  - Even if repricing w/o s/h approval permitted under plan
  - Applies only in year of next Comp Committee election

Negative Corporate Governance Quotient Factors:

- Equity plans that don't prohibit repricing w/o prior s/h approval
- ISS recommended WITHHOLD vote for 1 or more directors

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Other Issues

Treatment of non-exempt employees

- Worker Economic Opportunity Act – option gain included in "regular rate" of pay for purposes of FLSA overtime rules unless:
  - Not exercisable for 6 months or
  - Death
  - Disability
  - "retirement"
  - Change in Control

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Tender Offer: Process

Develop Exchange Ratio(s)	Tender Offer Open	TO Closes
• Based on current market value • May include a "buffer" to attempt to avoid incremental expense	• Distribute materials to participants • Allow elections for 20 days • Election is grant by grant • Allow changes to elections for 20 days • Distribute confirmations	• Implement Exchange • Compute fair value for exchange based on closing market value

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Tender Offer: Securities Issues

Why you have to do a Tender Offer:

- Section 13e-4 of Exchange Act
- Exception: No investment decision (e.g., reduce exercise price of NQs with no other change in terms)
  - The SEC could still take the position that this is a TO
- Exception for individually negotiated arrangements to a small group of people (10 people?)
- Difficult to launch TO if material corporate transactions are in the works

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Tender Offer: Securities Issues

What a TO means:

- Tender offer rules require public filing of Schedule TO plus all written communications
  - Schedule TO must be amended with any communications not previously filed
  - Caution regarding pre-commencement communications (some need to be filed)
- Keep open for 20 business days
  - Allow changes to elections
  - Confirmations on elections & changes
- Prompt payment
- All holders / best price

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Implementation: Administrative Issues

Mechanics of a Cancel/Regrant

- Old grant cancelled, new grant created
- Old grant "linked" to new grant to allow "comparison" and (perhaps) calculation of incremental expense
  - If your system does NOT link grants, find a way to reference them – you will need to access DTA from old grant at exercise
- Participant gets a new grant #, date, etc.
- If reports do not automatically filter out "cancellations" or if not entered as a Cancel/Regrant – consider filtering them out manually

New Grant

- New grant agreement
- New grant acceptance

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Implementation: Ways to Automate

Export grant data for valuation calculations

Import incremental valuations

- Many systems cannot do these calculations for you
- One time calculation, ongoing accrual & DTA
  - Spreadsheets?
  - Some tools / vendors can assist

Tender Offer Website

- Collect elections, run reports, send e-mails

Online grant agreements

- New grant, new agreements

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APPENDIX

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Institutional Shareholders

Fidelity: own voting standards on repricings – 52-week high isn't critical if the business case can be made and you are using a value-for-value exchange using a binomial model (Black Scholes, ISS or other)

Barclay's follows Glass Lewis model

Vanguard wants to see 52-week high cut off and value for value – policy similar to ISS – not likely to support repricings in this environment

State Street informally indicated that it does not intend to support any repricings in this market

Jennison is believed to be an ISS follower

BNY Mellon, Dimensional, JP Morgan, Wells Fargo, Wachovia, Wellington tend to follow ISS

Lord Abbott looks to ISS but makes own decision – was willing to vote for FormFactor in the 11th hour – *may* be influenced away from ISS

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How Far Underwater?

What % of options are > 30% or 40% or 50% underwater?

Weighted Average % of Shares Underwater?

Market Value		$ 9.00			
Over		30%			
Price	Underwater By	% Underwater	Shares Outstanding	Weighting	Threshold Shares
$ 12.00	$ 3.00	25%	1,000	25000%	0
$ 11.00	$ 2.00	18%	2,000	36364%	0
$ 8.00	$ -	0%	3,000	0%	0
$ 15.00	$ 6.00	40%	4,000	160000%	4000
$ 18.00	$ 9.00	50%	1,000	50000%	1000
$ 19.00	$ 10.00	53%	3,000	157895%	3000
Totals			**14,000**	**429258%**	**8000**
Weighted Average Underwater			30.66%		
% of Shares Over Threshold?			57%		

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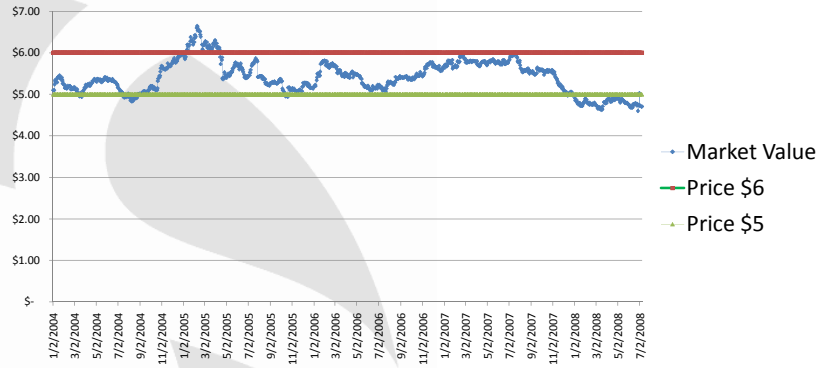
How Long Underwater?

How long underwater?

What % of time underwater?



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Potential Payouts

Original Option Award: 100

Strike Price: $20.00

Current Stock Price: $10.00

Potential Payout by Future Stock Prices:

Type of Exchange	Fair Value Old	Fair Value New	Exchange Ratio	Awards	Future Stock Price			
					$5.00	$10.00	$20.00	$30.00
No Exchange	$2.50	N/A	N/A	100	$0	$0	$0	$1,000
Options for Options	$2.50	$5.00	2 for 1	50	$0	$0	$500	$1,000
Options for Stock	$2.50	$10.00	4 for 1	25	$125	$250	$500	$750
Options for Cash	$2.50	$2.50	1 for $2.50	$250	$250	$250	$250	$250

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Types of Modification Accounting Under FAS 123(R)

Before ↓ After → Modification	Probable	Improbable
Probable	Probable to Probable Type I Example 13(a) Expense = at least equal the fair value of the award at the [original] grant date + Incremental Expense, if any	Probable to Improbable Type II Example 13(b) Expense = at least equal the fair value of the award at the [original] grant date + Incremental Expense, if any
Improbable	Improbable to Probable Type III Example 13(c) & (e) Fair value of new grant only	Improbable to Improbable Type IV Example 13(d) Fair value of new grant only

Not applicable if vest schedule not changed – goals before & after modification are the same.

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Examples: NQ Expires & FAS 123 APIC Pool

Post-adoption grant
DTA booked = $2,000 (Recognized Expense of $5,000 x 40% tax rate)
Tax deduction on expiration = $0
Entries on exercise:

	Debit	Credit	Calculation	Formula
Taxes Payable	$0		($0*40%)	Tax Ded * Rate
DTA (Reverse)		$2,000	($5,000*40%)	Rec Exp * Rate
APIC Pool	$2,000		[$0–($5,000 x 40%)]	Taxes Payable – (Total Exp * Rate)

*Does not apply to ISOs – no DTA booked for ISOs (tax deduction not anticipated).

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Examples: NQ Expires, No FAS 123 APIC Pool

Post-adoption grant
DTA booked = $2,000 (Recognized Expense of $5,000 x 40% tax rate)
Tax deduction on expiration = $0
Entries on exercise:

	Debit	Credit	Calculation	Formula
Taxes Payable	$0		($1,000*40%)	Tax Ded * Rate
DTA (Reverse)		$2,000	($5,000*40%)	Rec Exp * Rate
Tax Expns	$2,000		($0- $2,000)	Difference/ "Plug"

APIC Pool — No entry – No pool, so cannot be decreased

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