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"Hold Through Retirement": Maximizing the Benefits of Equity Awards While Minimizing Inappropriate Risk Taking

A Word From the Publisher

This issue contains two very timely pieces—a thoughtful and practical treatment of what to do about underwater options, entitled "A Coming Wave of New-Age Repricings? Not so Fast" and an important follow-on piece to our last issue.

Our September-October 2008 issue focused on the opportunity that companies now have to make a real improvement in their executive compensation programs by implementing hold-til-retirement requirements for equity awards. In the short time since we published that piece, the financial world has changed dramatically, and now the need for implementing HTR requirements has become even more relevant.

In fact, in view of the dramatic intervening economic events and the in-depth discussions and insights into HTR at our just-held October Conferences—the "3rd Annual Proxy Disclosure Conference," the "5th Annual Executive Compensation Conference" and the "16th Annual NASPP Conference"—it has become clear that a requirement to hold equity securities *until* retirement should be modified to require a hold *through* retirement, so that the executive is not incented to bail and, instead, remains focused on the company's long term goals beyond his/her own retirement. Throughout this issue, when we refer to an HTR policy, we mean "hold through retirement" instead of "hold til retirement."

Because of this important development and because we expect many companies now to focus on implementing HTR policies in time to address their upcoming "unnecessary and excessive risk" CD&A proxy discussion, we are devoting our lead article to this development.

—*JMB*

Setting the Stage for HTR

In the period of only several weeks since our last issue, we have witnessed not only historic changes to our financial system, but also rising anger over what are believed to be the results of a flawed executive compensation system. Federal legislation and shareholder concerns have now made it more important than ever for companies to consider implementing HTR requirements in time for the 2009 proxy season.

If It's Good Enough for Warren Buffett…

Expectations in this new world are perhaps best exemplified by Warren Buffett's recent notable investment in Goldman Sachs. As we noted in our September-October 2008 issue, Goldman Sachs already had in place a hold-til-retirement approach, specifying that the CEO, CFO, COO and Vice-Chairmen retain 75% of their equity awards (excluding IPO awards), while participating managing directors retain 25% of their comparable equity awards.

We learned from counsel for Goldman Sachs at the NASPP Conference session on Hold-Through-Retirement that under the terms of the Berkshire Hathaway investment, Goldman's CEO, CFO and co-Presidents (as well as their families and their estates) now must not sell more than 10 percent of *all* the common stock they own until the earlier of October 1, 2011 or until Berkshire redeems its $5 billion in preferred stock.

We also learned that the sale restrictions extend for three years beyond an executive's termination or retirement. Buffett's focus on aligning the interests of Goldman's senior executives with his own through an equity holding requirement should serve as a wake up call to both companies and investors that such requirements are emerging as an important part of the post-crisis world. [We

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have just posted the letter agreement setting forth these terms on CompensationStandards.com.]

Shareholder outrage over executive pay and unbridled walk-away amounts will likely ride the wave of the financial crisis fallout into the next proxy season. We have already learned from major institutional players that HTR requirements will be the subject of shareholder proposals and other activist investor efforts. Now is the time for companies to consider how to "get ahead" of this issue in time to implement policies that can be discussed in the 2009 CD&A.

Say-On-Pay

The focus on executive pay actions—such as implementing an effective HTR policy—will most certainly come to a head very soon if some form of "Say on Pay" (in other words, a mandated advisory vote on executive compensation) is enacted next year. The momentum for adoption of Say on Pay is clearly present—the House of Representatives passed a bill earlier this year and President-elect (then Senator) Obama introduced identical legislation in the Senate. While any legislative efforts will likely not occur in time for the 2009 proxy season, what companies disclose in 2009 will provide a very important backdrop for investors' voting decisions in 2010. This potential development heightens the need for CD&A disclosure addressing the compensation committee's review of the need for—and implementation of—an HTR approach that makes the most sense for the company.

Impact of the Emergency Economic Stabilization Act (EESA)

The EESA was enacted amidst great concern about the future of financial institutions in the United States. The legislation and implementing regulations impose significant new substantive executive compensation requirements on institutions participating in the program—including provisions that may make HTR requirements increasingly attractive for both financial institutions and non-financial companies.

<u>Limiting Unnecessary and Excessive Risks.</u> Among the executive compensation provisions in the EESA is a limitation that strikes at the heart of most executive compensation programs. Under the EESA, an institution must structure its executive compensation program to exclude incentives for its senior executive officers to take *unnecessary and excessive risks* that threaten the value of the institution.

The Treasury Department's rules implementing this provision of the EESA mandate that within 90 days of the first government capital infusion under the program, the participating financial institution's compensation committee must meet with the institution's senior risk officers (or persons acting in a similar capacity) in order to discuss and identify the features in the incentive compensation arrangements available to senior executive officers that could lead the executives to take "unnecessary and excessive risks that threaten the value of the financial institution." After identifying and evaluating the elements of the compensation program, the compensation committee must then limit the plan features that encourage such risks.

Going forward, the compensation committee of a participating institution must meet annually with the senior risk officers to discuss and review the relationship between the institution's risk management policies and practices and its senior executive incentive compensation arrangements. Further, the compensation committee must certify in the CD&A (if the company is public) that the compensation committee "has reviewed with senior risk officers the SEO incentive compensation arrangements and has made reasonable efforts to ensure that such arrangements do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the financial institution."

Note that a simple, yet elegant, governor on the "encouragement to take risks" that is inherent in all equity related incentive compensation (as well as cash bonuses) would be to add an HTR requirement so that an executive's risk related decisions will focus on long-term value creation.

A Broader Application

While the operation of this EESA provision will in many cases change the way compensation committees at financial institutions seeking government assistance look at their executive compensation packages, it should also have a broader effect on the compensation policies and practices of all public companies. In this context, at our "3rd Annual Proxy Disclosure Conference," John White, Director of the Division of Corporation Finance, asked the question: "Would it be prudent for compensation committees, when establishing targets and creating incentives, not only to discuss how hard or how easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target—with risk, in this case, being viewed in the context of the enterprise as a whole?" Clearly, the import of John White's question is that a risk-based approach to looking at compensation policies and practices is now more appropriate than ever, and this will be something that investors and the SEC Staff will be looking for in upcoming CD&As. Compensation committees will be viewed as falling behind if they are not asking themselves this critical question going into 2009.

How HTR Can Help—Now

While it remains to be seen what adjustments may emerge for compensation programs as a result of the EESA and a broader application of the "unnecessary and excessive risk" provision as contemplated by John White's speech, HTR is an approach that companies can implement immediately to address—at least in part—these concerns.

One obvious area of potential criticism of a financial institution's executive compensation program is the extent to which such program relies on equity compensation, given that there may often be some tension between the executive's incentive to raise the stock price for short term gain (perhaps through taking unnecessary or excessive risks) versus maintaining net interest margins or capital levels in order to ensure the safety and soundness of the entity. In other words, accumulated equity awards may have the potential to compel an executive toward a riskier "growth" approach that will boost the stock price by engaging in riskier trading, investment or lending operations. Even for those financial institutions that have hold-til-retirement policies in place (see, *e.g.*, our September-October 2008 issue at pg 3), it may be necessary to re-examine hold-til-retirement policies that have already been implemented through the lens of whether the institution's compensation programs encourage unnecessary or excessive risks. [We expect that those institutions will now want to extend their "holds" *through* retirement.]

A similar concern emerges with companies other than financial institutions, in that any significant concentration in equity compensation may push an executive toward riskier behavior that could boost the company's stock price in the near term, but could ultimately cause the company's failure in the long term.

HTR offers a straightforward way to address this tension, which will be present whenever equity comprises a significant portion of executive compensation. By requiring senior executives to hold a substantial portion of their earned equity awards for their entire career—and in fact through the beginning of their retirement as respected counsel and advisors are now suggesting—companies and their shareholders can achieve the benefits that we outlined in our September-October 2008 issue and at our October Conferences, which include:

- Better alignment of the executive's interests with the interests of shareholders;
- Encouragement of a long-term focus (and thereby discouraging unnecessary and excessive risk-taking);
- Fostering a company-wide ownership culture;
- Avoiding the problems with focusing on taking on more risk in order to temporarily raise the stock price and cash out; and
- Sending a reassuring message to shareholders and the markets that the CEO has committed to keep his skin in the game for the long term.

The Critical Need for Holding *Through* (Not Just Until) Retirement

We outlined the many reasons why companies should adopt hold-til-retirement policies in our September-October 2008 issue. However, we did not discuss one important consideration that companies must address when implementing any HTR requirement. While requiring an executive to hold equity awards *until* retirement goes a long way to promoting a long-term focus, there is potential that an executive could lose that long-term focus in the critical period right before retirement.

The ExxonMobil Experience

In discussing his company's HTR approach at the NASPP Conference, Jim Parsons of ExxonMobil noted that it was critically important to keep the executive's "eye on the ball" right through retirement. The last years of an executive's career tend to be the most valuable years, and thus you want an HTR policy that will encourage the executive to retain a long term focus when making big decisions that affect the company. If the executive knows that HTR requirements will lift as soon as retirement commences, the same potential for decisions promoting unnecessary or excessive risks may also arise, as the soon-to-retire executive may be seeking to maximize near-term stock returns to the detriment of long-term value.

As Jim Parsons noted at the Conference: "We want them thinking about their legacy. Are they going to build a lasting legacy at the company that's going to carry on year after year after they are gone? Are they laying a foundation that is going to continue to generate superior results year after year after year, not just go out on a good year or go out on a high note, but something that is really going to be sustainable year in and year out."

Picking an Appropriate Timeframe

How long the HTR requirement should extend after retirement will be an important consideration in designing any approach, and in many cases the length of the post-retirement restriction will depend on the other components of the policy (*e.g.*, how much of the executive's equity awards are "locked up"), the particular executives covered and the company's own culture and business.

At a minimum, we think that a requirement to hold for two years after retirement is necessary in order to avoid the potential problems that we have outlined above. Some companies may consider longer periods in order to avoid any excessive "short-termism" as executives approach their retirement. [Note that ExxonMobil's approach applies to restricted stock and requires the shares to be held (and not physically delivered to the executive—which also facilitates clawbacks) until ten years from grant or retirement—whichever is later.]

Implementing an HTR Policy Now

As was noted by counsel on the HTR panel, implementing an HTR requirement is the type of change that can be accomplished almost immediately. If a company is limiting the requirement initially to the CEO and the senior executive officers (*e.g.,* the NEOs), all that may be necessary is to get them in a room and have the CEO say, "Let's do it." In most instances, these executives are not selling significant amounts of equity awards in any event, so the imposition of an HTR policy will not substantially alter their practices or financial position.

With a policy applicable to the most senior executives in place, the company and the compensation committee may then consider whether HTR requirements should be extended to a broader employee group, or whether something going further than a mere policy might be implemented into the compensation structure (*i.e.*, ExxonMobil's approach).

Given so many unprecedented recent developments, companies would be well served by putting HTR requirements for the CEO and NEOs in place by the end of 2008 so that the policy—and the beneficial effects for the company and shareholders—can be described in the company's upcoming 2009 proxy statement. In any risk-based CD&A evaluation of compensation policies, HTR requirements should play a key role in explaining how a company avoids paying executives in a way that might encourage taking unnecessary and excessive risks, while at the same time encouraging them to act for the long term.

Resources for HTR Implementation

We urge our readers to be proactive here (and head off potential embarrassment to your CEO and board) by raising the importance of implementing an HTR policy now in time to address in your upcoming proxy statement.

As for resources, you will want to have in hand (a) the September-October 2008 issue of *The Corporate Executive,* (b) actual examples of policies and disclosures posted in the "Hold Through Retirement" Practice Area on CompensationStandards.com, and (c) the CD of the HTR panel from the NASPP Conference which addressed the latest considerations in implementing effective HTR requirements (with Marc Trevino of Sullivan & Cromwell, who has implemented more HTR policies than anyone we know, and Jim Parsons, who drafted the ExxonMobil approach). The Audio CD of the Conference can be obtained at NASPP.com.

Underwater Options

Given current market conditions, many companies may now be considering repricing underwater stock options. There is a lot of misinformation out there about whether—and how—this may be accomplished. Old school repricing—reducing the exercise price on outstanding options or substituting new options for old out-of-the-money ones on a one-for-one basis—are obsolete. Most option plans currently in place contain an express prohibition on these types of practices in the absence of shareholder approval; a direct result of ISS objections to historical repricing practices.

Instead, companies considering option exchange programs will likely grant new options (or full value awards) for old out-of-the-money options on a value-for-value basis (*e.g.*, employees receive new awards equal in value to the underwater options exchanged). In addition, both awards should be counted against the number of shares available for grant in the company's stock plans. Employees must be required to make sacrifices to participate in these programs, usually in the form of a new vesting schedule and a reduced number of shares. The Radford Surveys + Consulting unit of Aon reports that exchange ratios of underwater options range as high as 1:5 (one new at-the-money share for every five underwater shares cancelled).

Tender Offer Requirements

Because employees are agreeing to give up benefits in exchange for the new grants, unless exchanges are individually negotiated and limited to a handful of employees, these programs must comply with the SEC's tender offer requirements, including registration as exchange offers with the SEC under a global exemptive order issued by the SEC back in March 2001. (See the March-April 2001 issue of *The Corporate Counsel* at pg 7.) This order provides relief from Exchange Act Rules 13e-4(f)(8)(i) and (ii), allowing companies to treat option holders differently depending on their individual circumstances, but still requires companies to file a Schedule TO (no small undertaking) and to give employees up to 20 days to decide if they want to participate in the program. Public companies that want to undertake an exchange program should be prepared to buckle down for the long haul; the program will require onerous (and expensive, in terms of attorneys' fees) SEC filings, extensive and detailed communications to employees, and complicated financial reporting.

Other Obstacles and Considerations

There are a number of other obstacles to undertaking an option exchange program:

- For Section 162(m) purposes, both the cancelled underwater option and the new grant count against the maximum number of shares that can be granted to an individual employee (this maximum is necessary to ensure that options granted under the plan are considered performance-based compensation and are exempt from the $1 million cap on the company's tax deduction that applies to non-performance-based pay to named executive officers—see our May-June 2001 issue at pg 7).
- For accounting purposes, the exchange is considered a modification, invoking complicated accounting under 123(R) and potentially triggering additional charges to the company (see our January-February 2006 issue at pg 2). For purposes of expense attribution, if employees terminate after the original vesting dates but before the new, the expense for the original option is still recognized but the incremental cost is not; we understand that few, if any, stock plan accounting systems can support this, so prepare for a lot of manual processes (and associated internal control risk).

Not only is the expense attribution more complex, but the valuation itself is problematic in terms of estimating an appropriate expected term and supporting that estimate. The expected term for new option grants should differ from the expected term for the underwater options, and both will likely differ from the expected term assumed back when the options were granted as in-the-moneyness, the option price, and current economic conditions all impact exercise behavior.

Given the complexity here and the fact that the accounting consequences must be stated in the Schedule TO filed for the exchange, companies would be wise to have their understanding of the accounting treatment "blessed" by their accounting advisors before proceeding with the exchange.

Finally, 123(R) requires that companies describe the exchange program in the stock plan footnote to their financial statements, including the terms of the program, number of employees that participated in it, and any incremental compensation cost recognized as a result of it. This is not a one-time disclosure; the company must continue to include it so long as expense for the exchange is recognized in any of the periods presented in the company's income statement.

- The NYSE and Nasdaq require that companies obtain shareholder approval for the exchange unless repricing without such approval is expressly permitted in the plan (see our January-February 2006 issue at pg 3).

- For ISOs, the exchange is considered a cancellation and regrant, triggering recalculation of the $100,000 limitation. Just as under 162(m), in some situations shares in the original option and the new option will count against this limit twice (see our May-June 2005 issue at pg 10). In addition, the two-year holding period for a qualifying disposition starts anew as of the regrant date. Finally, where an offer to reprice an ISO is outstanding for more than 30 days, the ISO is deemed to have been modified (*i.e.*, cancelled and regranted) as of the offer date. This could potentially disqualify even those ISOs held by employees that don't choose to participate in the exchange, *e.g.*, if the regranted option exceeds the $100,000 limitation (see our January-February 2006 issue at pg 3).

- For 409A purposes, the exchange is also considered a cancellation and a new grant. So long as the exercise price of the new option is equal to or greater than the current FMV, this shouldn't be a problem for a one-time exchange, but the preamble to the final 409A regs states that a series of repricings could indicate that the exercise price was never fixed to begin with and, therefore, the option never met the requirement to be exempt from treatment as deferred compensation.

- Following a repricing of options granted to named executive officers (which we strongly advise against, see below), the Summary Compensation Table must include the compensation cost that is recognized (either immediately or over the requisite service period) for the incremental fair value of the repriced award, consistent with Paragraph A.51 of FAS 123(R), and the incremental fair value of the repriced award must be disclosed in the "Grant Date Fair Value" column of the Grants of Plan-Based Awards Table. Details about the repricing must be discussed in the narrative discussion accompanying the Summary Compensation Table and the Grants of Plan-Based Awards Table and in the CD&A. And, for Section 16 purposes, the exchange (both the cancellation of the underwater option and the new grant) must be reported on Form 4 within two business days.

Still Considering an Option Exchange, Even With All the Obstacles?

Even with that daunting list of obstacles, some companies are still considering an option exchange program. Companies considering repricing programs must weigh several factors. First, with stock price volatility so high, the accounting cost of new grants would be significant. Volatility is one of the key factors in option pricing models (see our March-April 2007 issue at pg 5) and some companies may want to hold off on new grants until the markets stabilize so that the accounting hit is not as drastic. Second, many employees are shell-shocked by the recent market decimation and are looking for cash compensation, instead of stock options. Repricing may be viewed as a way to restore employees' faith in the company's stock option program.

Finally, there are issues relating to stock plan expense and market overhang. There is no way for the company to recoup the P&L expense recognized on underwater options. The only way the company reverses any of the expense is if employees terminate prior to when the options vest. It's not to anyone's advantage (not the company's, nor its shareholders', nor its employees') for the company to be in a position where it hopes that employees resign. In some cases, if the options expire underwater, the company will have to recognize additional expense for them related to the tax benefit booked for P&L purposes but never realized on their corporate tax return (see our January-February 2005 issue at pg 2). Now that the options have been granted, the best the company can hope for is that they produce some benefit to the company in the form of employee retention and motivation, to offset the expense recognized for them. An option exchange program represents an opportunity to wipe the slate clean (but not from an accounting standpoint—there's nothing that can be done about the expense for the underwater options) and grant new options that produce the benefit the company isn't realizing from the underwater options. Companies may also see repricing as an opportunity to reduce plan dilution.

Since September 1, there have been only ten tender offer filings (under the form type "SC TO-I" on Edgar) for option exchange programs: Advanced Analogic, Exar, Quantum Fuel Systems, Retractable Technologies, Zhone Technologies, Synopsis, MGM Mirage, Maxim Integrated Products, Isle of Capri Casinos and UTStarcom.

ISS Supports Repricing Only for Compelling Reasons

A significant factor to consider is the position of RiskMetrics' ISS, and other shareholder advisory services, on repricing, as their support is likely necessary to obtain the shareholder approval required for these programs. For quite some time, ISS has employed a case-by-case approach to determine whether to support programs in which options are surrendered and returned to the plan reserve for use in connection with future grants. If the shares are returned to the plan, the "shareholder value transfer" and burn rate tests are triggered (notably, the "summary" policy on the ISS website only references the burn rate test). While ISS's stated preference is to see the surrendered shares exit the plan, each program is evaluated on a case-by-case basis.

Here's the relevant excerpt from ISS's policy manual:

> Treatment and Terms of Surrendered Stock Options
>
> Under some option exchange programs, surrendered options will not be available for future grants. However, other option exchange programs permit the recycling of surrendered options and allow re-issuance of these options for future grants. In cases where the surrendered options are added back for re-issuance, ISS will adopt a two-step process in its analysis.
>
> The first step is to determine if there is a value-for-value exchange and if executive officers and directors are excluded from participating. *The second step is to analyze the cost of re-issuance of surrendered options by evaluating the total cost of equity plans. The three-year burn rate policy is also applicable if the surrendered options are added back to the company's equity plan(s) for re-issuance.* ISS will also consider the terms of surrendered options, such as the grant date, exercise price and vesting schedule [empasis added].

ISS's general view is that option repricing is never a "good" practice. Repricing weakens—and if done on a serial basis, destroys—the very incentives that make up the foundation of a stock option program. Sometimes, however, ISS will support repricings if a board's arguments for the program are clear and compelling and the proposed action is aimed at a specific problem that threatens the long-term health of the company. If—and only if—a board makes a compelling case for the necessity of an adjustment to its options, ISS then considers the proposed structure. In terms of structuring the program, ISS prefers that the exchange exclude top executives and directors, be cost and risk neutral, and reset or extend vesting.

Boards Will Need to "Sweeten the Pot"

In the current market environment, boards will need to make concessions to large shareholders to win broad support for option exchange programs. While boards often chant "retention" in their efforts to soften opposition to repricings, the market rarely supports the argument and companies rarely back up the rhetoric with action. Investors—and proxy advisors like ISS—will be looking for real action this time around and they now have the leverage to get it. At a minimum, vesting must be reset to demonstrate that the program is intended to retain employees. Another way companies can demonstrate a retention motive is to put "super glue" into the seats of key value-driving employees via the use of some version of hold-til-retirement, in addition to vesting enhancements (recall ExxonMobil's approach that requires 50% of the grant to be held for ten years or until retirement, whichever period is *longer*—see our September-October 2008 issue at pg 8).

As ISS's Pat McGurn noted at CompensationStandards.com's recent Executive Compensation Conferences, the upcoming season's biggest compensation issue will be the use of "R&R": "Repricings" and "Resetting the Bar on Performance Plans." Look for ISS to announce policy changes in December that will deal with this issue. ISS's consulting arm has already announced a RiskMetrics Group Option Advisory Service, "designed to help U.S. companies deal with a significant number of outstanding stock options, which are underwater."

What About the "Rank-and-File"? The Sad Reality

While many might agree that options granted to the board and senior management should not be repriced—because it undermines *ex ante* incentives to create shareholder value—some companies find this is a more complex issue when dealing with options granted to rank-and-file employees. Even in difficult economic times, high-performing employees, even those in the rank-and-file, may be able to find jobs elsewhere. Moreover, some rank-and-file employees may be less able to weather the loss on their options, particularly if their pay package is overly weighted with these incentives. [This raises the question of why options are granted to lower level employees. Some economists think it makes little sense to give options to employees; it is a risky form of compensation, worth less to the employees than it costs the company and shareholders, and is unlikely to have any useful incentive effects because rank-and-file employees rarely feel they have any direct influence on the company's stock price. Where a company is married to the idea of stock compensation for rank-and-file employees, we think there may be better approaches—see below.]

On its face, the argument that rank-and-file employees individually can have little effect on shareholder value and, thus, the incentive problem associated with repricing executive options does not apply, seems to hold water. But, we have to question the true motivation behind many of today's option exchange programs for the rank-and-file. *The big ugly secret about repricing is that the shares returned to the pool will likely wind up in the hands of senior management.* For example, assume a company has 160 million options that are underwater, with 50%, or 80 million options, held by executives. If all employees, including executives, exchange their options on a 1:8 basis, the company would return 160 million shares to the kitty and issue 20 million replacement options. This results in a net increase to the plan of 140 million shares; presumably, some of the replenished pool will be allocated to the non-executives, but we worry that the bulk of it will go to executives (*e.g.,* the company already has a history of granting at least half its shares to executives).

If senior management is excluded from the repricing, which is required by ISS, then approximately 80 million options would be eligible for the exchange. On a 1:8 basis, only 10 million new options would be granted for the 80 million shares returned to the pool. It isn't difficult to guess who gets the 70 million shares left in the plan after the new grants have been doled out to the rank-and-file (hint: the senior executives hold 80 million underwater options and did not get a chance to participate in the exchange).

<u>Preventing Abuses.</u> The fix here is to prevent senior executives from indirectly benefiting from the repricings by not allowing excess shares (*i.e.*, on a 1:8 exchange, the seven surplus shares) to be added back to the kitty. This forces the company to ask shareholders to approve a new share authorization if they want to make additional, off-cycle grants to executives. The request would be subject to the full ISS share value transfer test and review by other institutional shareholders for compliance with their overhang guidelines.

Wait It Out

For those companies that are considering option exchange programs, we have a number of suggestions; first and foremost is to wait. Any action to address underwater options is a serious undertaking that shouldn't be rushed. Moving too fast could result in any number of worst case scenarios. The stock price could recover, making the whole program unnecessary, or the stock price could continue to decline, leaving the company with repriced but still underwater options. We know one company that repriced earlier this year and has now seen their stock price drop by another 50%; if only they had waited. Until the company really begins to feel pressure in the form of increased employee turnover and decreased morale, we don't believe that companies should even begin considering an exchange program.

Moreover, with stock price volatility so high now, the value of underwater options is likely to far exceed their perceived value by participants, making a value-for-value exchange far more costly. Waiting for steadier markets allows an option exchange to be based on more realistic values.

<u>Do Annual Grant Programs Make Repricing Unnecessary?</u> Where a company makes regularly scheduled, *e.g.*, annual, grants to employees, we question the need to reprice options at all. Employees will receive new at-the-money options at the current price with vesting schedules that serve to retain them. Many employees are grateful to receive their regularly scheduled option grants at the current stock price, as the depressed market provides employees with a real chance of gains if the stock price recovers. Employees may even be relieved to know that the company isn't cutting back stock compensation.

Employees receive only those options they were scheduled to receive, preserving the originally intended compensation structure and pay-for-performance inherent in the company's option plans. Because the grants are already scheduled, there should be shares in the plan reserves to cover them or, if additional shares are needed, the company is requesting these shares in the time frame originally anticipated when the plan was implemented, rather than asking shareholders to approve an extra allocation of shares (assuming, of course, that the company has been able to appropriately manage its plan reserves).

<u>Making Annual Grants Contingent on Cancellation of Underwater Options.</u> Another thought is to require employees to give up their underwater options in exchange for the scheduled grants they would be receiving anyway. We discussed this idea

in our January-February 2006 issue (at pg 1). By requiring employees to give up their underwater options, the company can offset the cost of the new grants with the value of the underwater options. We received a number of questions about this; to clarify—the company still isn't able to reverse any P&L expense for the underwater options (and if the options aren't fully vested yet, the company continues to recognize the remaining unamortized expense), but the expense for the new grants is reduced by the current fair value of the underwater options. If the shares in the cancelled options aren't added back to the plan reserve, the program also reduces plan overhang (enough shares could be added back to cover the new grants, but no more).

Exclude Executives

It's so obvious, it hardly bears saying, but top on our list of unacceptable practices for an option exchange program is including executives (and directors). Executives and directors do have a direct influence on the company's stock price and should not be rewarded for a drop in price. Shareholders don't get a "do over"; senior management shouldn't either. And excluding senior management avoids the challenges relating to proxy disclosure and Section 16 reporting described above.

We don't believe there is any circumstance that justifies repricing executive or director options—directly or *indirectly* (*e.g.*, by beefing up the plan reserve with shares from cancelled underwater options held by the rank-and-file, so that senior management can be loaded up with new awards).

No Increase in the Plan Reserve

To prevent abuse in the form of new grants to senior management, it is critical that the plan share reserve is not increased by surplus shares resulting from the exchange ratio. We've seen several exchange programs already that retired surplus shares and we believe this practice should be the standard for all companies.

Other Critical Program Components

In addition to the three absolute musts we've already mentioned, we have a number of other practices that we think are critical for any option exchange program.

Coordination with Regularly Scheduled Grants. Where a company has a regularly scheduled grant program (*e.g.*, annual grants), the underwater options should be exchanged for regularly scheduled grants. If this isn't possible due to timing considerations, the next regularly scheduled grant should be skipped.

Reset or Extend Vesting. In keeping with the *de rigueur* stated objective of option exchange programs (*i.e.*, employee retention), there absolutely must be some extension of vesting in the new grants. In no event should the new grants be fully vested; our preference is a complete restart of vesting (and, we especially like the approach that 50% of the grant shares be retained for the longer of ten years or retirement).

Share Sacrifice. Employees are tendering options that are worth significantly less, on a per share basis, than the new grants they are receiving; this discrepancy in values must be reflected in the size of the new grants, which should be for substantially fewer shares. This is a good test of whether or not the company has waited long enough before implementing the program; options should be underwater far enough and long enough that employees are willing to agree to a severe exchange ratio. If a company feels like it has to offer employees a favorable exchange rate for them to agree to the program, then we question whether the program is really necessary.

No Economic Benefits Other Than a Reduced Price. It goes without saying that the new options should be granted with a price equal to or above the current FMV; granting discounted options sends a clear message the company doesn't think the stock price has hit bottom yet and, in any event, the options would be deferred compensation subject to Section 409A (see our November-December 2004 issue at pg 6). Likewise, the contractual term of the option should not be extended; some companies have even reduced the term for replacement options.

Not Just Underwater, But Buried At Sea. Options included in the exchange should be significantly underwater; we like the guideline promulgated by some investor advisory services that the option price should be higher than the company's 52-week high. The length of time options have been underwater is also a factor. We think options should be underwater for at least one year, if not longer, before the company considers an exchange program. Repricing is never appropriate for a momentary dip in the company's stock price.

Necessary to Avoid Additional Tax Expense. Before considering an exchange, the company should also be in the position where the underwater options are likely to result in additional tax expense if they expire unexercised. Not only that, but this danger has to be imminent (*i.e.*, the underwater options are scheduled to expire in the next few years, they aren't newly granted options with their full ten-year term left to run).

Shareholder Approval. Shareholders have experienced an actual loss (as opposed to employees, who haven't yet invested any funds in the stock); no one is offering them a do-over. Therefore, we believe that shareholders should have the right to vote on all exchange programs. In some ways, this is moot—for most public companies, shareholder approval is mandatory for any exchange programs anyway. But even where it isn't, we believe companies should voluntarily seek approval for the program. Companies that ignore this warning are likely to see retaliatory action from shareholders (*e.g.,* the next time shareholder approval is requested for a stock plan or compensation committee members are up for reelection).

Cap Option Gains. By repricing the underwater stock options, the company has limited employees' downside risk; it seems symmetrical to also limit their upside risk. Mike Kesner of Deloitte, who feels as strongly as we do about the inappropriateness of most repricings, suggests capping the gains on the new options at 200% of their Black-Scholes value. This would also help alleviate the impact of current high stock price volatilities on the new options' fair value.

Is Repricing a Real Necessity? We believe the company should be experiencing, or expect to experience, serious retention or other issues with personnel if the underwater options aren't addressed. Where employees are not making an issue out of their underwater options, we question whether it is necessary to undertake the expense, risks, and administrative burden inherent in an exchange program.

Time to Consider a Change in Strategy

For companies that do feel they have no other alternative than to undertake an exchange program, we also have to question whether broad-based stock options are an appropriate form of compensation. Ideally, stock options are granted to individuals that understand both the rewards they offer and the trade-offs at risk in exchange for those rewards. Likewise, if stock options are to function as a driver of company performance, then the individuals receiving them should feel they have some control of the ultimate outcome (*e.g.*, the ability to influence the company's stock price). Stock options are most effective when used in this manner; if the goal of the company is to merely encourage stock ownership among rank-and-file employees, we think there are better approaches and programs.

Regularly Scheduled Grants. Regularly scheduled grants, *e.g.*, annual, can alleviate the need to reprice. Underwater options are a particular problem if employees hold only one grant, *e.g.,* that was made upon hire. If employees receive options on an ongoing basis, some will most certainly be made when the stock price is high, but others will be made when the stock price is low; it is less likely that all of an employee's options will be underwater, and, even if that is the case, employees can anticipate receiving new grants at the low price. An even better practice might be to divide annual grants into two semi-annual grants or four quarterly grants—a form of dollar-cost-averaging for stock options (see our September-October 2006 issue at pg 7).

Likewise, loading up new hire grants can turn out to be an unfortunate practice when the stock declines in value. Rather than granting large options to employees when they are hired, before employees have even proven themselves, we'd like to see companies grant smaller options at hire, saving their plan reserve for ongoing grants to employees.

Employee Choice Programs. We think that employee choice programs have a lot of potential as well. Under this type of program, employees are allowed to elect to receive a portion of their compensation in a variety of vehicles. For example, employees might be given a choice between receiving stock options, performance-based awards, or time-based full value awards (or even cash). The amount of compensation paid to employees under each choice is adjusted based on the associated risk level (*e.g.*, employees that elect stock options receive larger grants than those that elect time-based full value awards).

Where the company properly educates employees about the risks and rewards up front and employees make an informed decision to accept the risk of stock options in exchange for the potentially greater upside, refusing to reprice the options when they end up underwater is the most logical course of action. Repricing would be unfair to those employees that choose lower potential rewards in exchange for less risk (*i.e.*, employees that choose restricted stock).

Performance-Based Full Value Awards. Another approach to consider is switching from options to performance-based full value awards. These arrangements are never underwater and, by allowing the company to attach non-stock price related performance hurdles, address the criticism that stock options don't incentivize the rank-and-file. And, assuming the performance goals are not tied to the company's stock price, if the goals aren't achieved and the awards aren't paid out, the company doesn't recognize any expense for them.

Reconsider Your ESPP—Our Favorite. In our January-February 2007 issue (at pg 1), we suggested replacing broad-based option programs with ESPPs (tax-qualified or not) and we still think this idea has a lot of merit. ESPPs do a much better job of encouraging employee ownership; in the 2007 NASPP Stock Plan Design and Administration Survey, 79% of respondents indicated that employees hold the stock acquired under their Section 423 ESPP for an average of six months or longer (61% for a year or longer). The data is even better for non-qualified ESPPs; there, 89% of respondents indicate that employees hold for an average of six months or longer (81% for one year or longer). That holding pattern is simply unheard of for stock options, where employees routinely flip the shares (for all practical purposes, they're forced to sell to cover the option price and taxes).

[Regarding all those forced sales, readers who have not yet converted their cashless exercise programs to "net exercises"—which, among their many other benefits, encourage share retention—should re-read our March-April 2008 issue and listen to the audio from the excellent session on net exercises at the NASPP Conference. We encourage our readers to take advantage of the enclosed order form for the Conference audio CD (or visit Naspp.com to place your order), which also contains many other important sessions, such as the keynote presentation on "Having the Hard Conversation: Top Consultants and Directors Share Their Approaches," and panels on restricted stock and units, hold-through-retirement policies, termination and forfeiture provisions, global stock plans, mergers and acquisitions, IFRS 2, performance plans, and the ever-popular "IRS and Treasury Speak" session.]

ESPPs are also never underwater so you never get into this mess—if the stock declines in value, the purchase price is a percentage of the FMV on the date of purchase. And ESPPs offer numerous other advantages over stock options, *e.g.*, better shareholder optics, less expensive on a per-share basis and overall, and expense is only recognized for employees that choose to participate.

If your company has an ESPP, now is a great time to promote it to employees. Interest rates are low, so the return employees are likely to realize from the ESPP could exceed their other investments. (We've discussed in the past why ESPPs make a lot of sense in a down market—see our November-December 1998 issue at pg 1.) If you don't have an ESPP, now is a great to time to implement one—doing so could alleviate the need to address your underwater stock options.

Follow-Up: Modifying Stock Options After Termination

In our May-June 2008 issue (on pg 8), we discussed a scenario in which an option is modified after the optionee has terminated to extend the post-termination exercise period by two years. We concluded that, because the modification occurs after the optionee is no longer an employee and extends the exercise period for longer than a year, the option would no longer be within the scope of FAS 123(R) and would most likely be subject to liability (*i.e.,* mark-to-fair value) treatment.

A reader questioned our conclusion on the basis that the modification is in connection with the optionee's termination (and, it follows, employment). Because of this, the reader felt that the option should remain within the scope of 123(R) (which governs how to account for stock issued in payment for services as an employee).

We checked with practitioners at two of the major accounting firms; neither disagreed with our conclusion but one practitioner felt that there may some room for interpretation. The practitioner felt that where the modification occurs shortly after the optionee's termination, in some circumstances, it might be appropriate to continue to account for the option under 123(R). Ultimately, the treatment would be based on the facts and circumstances involved. Factors that would argue for the option to remain under 123(R) would include that the modification is in connection with the optionee's termination, that it relates specifically to the impact of said termination on the option (*e.g.,* as in our scenario, where the option is modified to extend the post-termination exercise period), and that the modification occurs shortly after the optionee's termination. A situation where the modification is unrelated to the termination (*e.g.,* a repricing) would argue for the option to become subject to other GAAP, as would situations where the modification occurs after a lengthier time period has elapsed.

As the appropriate conclusion is highly fact-specific and because we found there to be some difference in opinion among practitioners, we recommend readers consult their own accounting advisors before taking action.

A Timely Heads-Up: Disclosing Pledged and Hedged Shares

Readers will not want to miss the timely discussion and pointers in the upcoming issue of *The Corporate Counsel* that David Lynn has just drafted, containing important proxy disclosure CD&A guidance (and new obligations) regarding pledged and hedged shares. It also covers margin account sleepers that many of us have overlooked. Any of our readers who may not yet subscribe to *The Corporate Counsel* should take advantage of the No-Risk Trial just to access this important issue.

Insider Trading Procedures and Margin Account Pitfalls

We should also mention the important heads-ups and practical pointers that we have just written for the Fall issue of the *Compensation Standards* newsletter to help all our readers who are responsible for insider trading compliance and pre-clearance procedures—especially during these high risk times for officers and directors. The newsletter is part of your CompensationStandards.com membership. Extra copies, for distribution to your directors and insiders, are available at a nominal cost. (Anyone whose company or firm is not yet a member of CompensationStandards.com, should take advantage of the No-Risk Trial to gain access to the newsletter as well as the ongoing critical guidance during the challenging months ahead.)

It's Here! Lynn, Romanek & Borges' Executive Compensation Treatise

We just mailed Lynn, Romanek and Borges' "The Executive Compensation Disclosure Treatise & Reporting Guide" to the many of you that ordered it. It is impressive: over 1000 pages and full of explanations, annotated sample disclosures, analysis of possible situations that you may find yourself in, etc. It's great to have Mark Borges joining David Lynn as part of our Treatise—and now our ongoing *Annual Service*—team.

Electronic Version Also Available on CompensationDisclosure.com. Those that order the Treatise also gain immediate access to the electronic version of the Treatise on CompensationDisclosure.com, that will unlock the wealth of practical knowledge in the Treatise for instant reference as you grapple with your upcoming proxy preparation.

The New *Disclosure Updates* Newsletter

We are pleased to announce that Mark Borges has agreed to keep us all updated on the newest best practices and guidance through our new *Disclosure Updates* newsletter. Subscribers to the Treatise receive this quarterly *Updates* newsletter as part of the *Annual Service* that accompanies the Treatise (at no charge), in which Mark and David Lynn will keep you abreast of all the latest guidance that you need to know. You will not want to miss the first issue—which was just published this week. It focuses on key new disclosures all companies will need to address in the wake of EESA and other regulatory responses to the crisis. Subscribers will receive the second issue of *Updates* in early January, with plenty of last-minute critical pointers for your proxy disclosures.

We thank the many of you that have already ordered the Treatise. And thank you to all those who have sent us encouraging words on this project. We intend to have this be *the* ongoing resource for proxy disclosure (akin to what the Romeo & Dye publications are for Section 16). Those that have not yet signed up, please use the enclosed No-Risk order form or, to save time, go directly to CompensationDisclosure.com to gain immediate access to the *Updates* newsletter as well as the online Treatise.

"The SEC's New Corporate Website Guidance: Everything You Need to Know—And Do NOW"

Readers will not want to miss our upcoming major webconference with the foremost experts—including Tom Kim, Chief Counsel of the SEC's Division of Corporation Finance—who will address head-on many of the most important questions that practitioners need to know—"The SEC's New Corporate Website Guidance: Everything You Need to Know—And Do NOW." There will be no charge for this critical webconference for those that subscribe to *InvestorRelationships.com*. To receive our Regulation FD Roadmap in our Fall issue of *InvestorRelationships.com* and to access this critical webconference, we encourage all our readers who have not already done so, to take advantage of the no-risk membership offer for InvestorRelationships.com—And, make sure that all your corporate governance and IR people are taking advantage of this invaluable resource during these rapidly changing times.

Upcoming Critical Webcasts

We have a number of important webcasts coming up, including:

- DealLawyers.com's video web conference—"Fundamentals of Investing in Public Companies" (11/17)
- InvestorRelationships.com's conference—"The SEC's New Corporate Website Guidance: Everything You Need to Know—And Do NOW" (1/14)
- TheCorporateCounsel.net's webcast—"Forecast for 2009 Proxy Season: Wild and Woolly" (1/20)
- CompensationStandards.com's webconference—"The Latest Developments: Your Upcoming Proxy Disclosures—What You Need to Do Now" (1/21 and 1/28)
- DealLawyers.com's webcast—"Implementing the New Cross-Border Rules" (1/22)
- Section16.net and NASPP's webcast—"Alan Dye on the Latest Section 16 Developments" (2/3)

(Make sure that all your memberships have been renewed—or enter No-Risk Trials—so that you don't miss any of these important webcasts.)

It's Renewal Time

As all subscriptions to *The Corporate Executive* are on a calendar year basis, renewal time is upon us. Please return the enclosed Renewal Form or go to the "Renewal Center" on TheCorporateCounsel.net to renew your subscription. (Note the reduced price when you renew your subscription to *The Corporate Counsel* at the same time.)

—JMB

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