Net-Settled Stock Option Exercises

Considerations and Analysis

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Since the publication in the March/April 2008 issue of The Corporate Executive regarding net-settled options, there has been a heightened interest in these instruments throughout corporate America. The purpose of this white paper is to explore several issues with respect to net-settled options that will be of interest to companies actively considering implementing such a program. We will focus on some of the administrative and international issues that have not been highlighted in the published materials thus far.

What are Net-Settled Stock Option Exercises?

A net-settled stock option has the form of a traditional option with a specified exercise price, term, vesting provisions, etc. The difference between a traditional option and a net-settled option is that the exercise of the option may, or in some cases, must be accomplished by withholding the exercise price from the number of shares that would otherwise be delivered upon a cash exercise of the option. In effect, a number of shares will be delivered to the option holder equal to the “spread” on the option at exercise.

To use the example from The Corporate Executive, assume an option of 100 shares is granted with an exercise price of $10 a share and exercised when the fair market value of the stock is $25 a share. In this case, 40 shares of the 100 shares would not be delivered but would instead be retained by the company as payment of the $1,000 exercise price for the option (100 shares times $10 per share exercise price). The option holder receives 60 shares directly from the company in settlement of this option exercise. There would be no market transaction and the number of shares outstanding would increase by 60, not 100 as would be the case with a traditional option exercise.

Although similar in economic effect to stock-settled SARs, stock swap exercises, and pyramid exercises, there are differences that are relevant to the tax, legal, and administrative analysis of the exercise method. In a stock swap exercise, the employee tenders previously held shares to pay the exercise price. Using an attestation approach, the employee might not actually tender the shares but merely attest that he or she owns the shares. In a pyramid exercise, an employee first exercises an option using a traditional method for one share and then tenders that share in exercise of other options and repeats this process until the option is fully exercised. Ultimately, the only amount the employee pays for the exercise is the exercise price for one share. In effect, net shares are received, similar to a net-settled option exercise.

As pointed out in The Corporate Executive article, FAS 123R has eliminated the adverse accounting treatment that otherwise would apply to net-settled, pyramid, and swap exercises. The accounting treatment for net-settled options would be essentially equivalent to that for a cash exercise or a cashless exercise through traditional option exercise methods.
Benefits of net-settled options

The benefits of net-settled options have been widely publicized through The Corporate Executive and The NASPP Advisor publications. We will briefly summarize them here.

First, net-settled options can reduce dilution as compared to a regular exercise of an option over the same number of shares, since only the net shares issued are outstanding. In a regular option exercise, the full number of shares subject to the options are issued by the company and sold into the market or are otherwise outstanding. Netting shares could reduce the need for company repurchase programs. Further, compliance issues with insider trading blackout periods and the need for 10b5-1 trading plans can be alleviated. While Form 4s would still need to be filed, if no shares have been sold to cover taxes, there are no sales to report on Form 4. In addition, by using net-settled options, there could be lower share utilization in the plan, assuming the plan only counts net shares issued against the share authorization. As a result, the life of the plan share pool may be extended. Finally, the option holder would avoid broker fees on the sale of shares that would occur in a regular cashless exercise.

Disadvantages of Net-Settled Options

There are several disadvantages of net-settled exercises which have also been publicized.

The first, and most obvious, is the lack of cash flow to the company. In a normal option exercise, the company will receive the exercise price in cash, either directly from the employee or through the same day sale on the market. In the case of net-settled options, there is no positive cash flow to the company. This may or may not be significant, particularly if a company was otherwise using cash to repurchase shares in the market to avoid dilution.

The issue of share usage in the plan and the various issues regarding institutional shareholder treatment of this form of exercise have been well publicized as well. ISS/RiskMetrics counts the gross number of shares for net-settled options instead of only the net shares issued. Other advisory firms may be using the same method. Also, in connection with the shareholder value transfer analysis performed by ISS to determine overall equity plan cost, net-settled options are treated as full value shares and all shares that could possibly be granted as net-settled options are assumed to be granted as such. As a result, ISS/Risk Metrics may analyze a higher cost for net-settled exercises than would otherwise be applicable for traditional options.

Another potential negative impact can occur with the use of net-settled exercise with incentive stock options. Adding this method of exercise for an ISO could be considered a modification under IRS Section 424(h), disqualifying existing ISOs to which this feature is added. Also, it should be noted that the shares withheld for an ISO would be considered a Disqualifying Disposition for the participant, causing more complex taxes, even if the ISO were not generally disqualified. Of course, to implement a net-settled
option program, the company would have to make appropriate modification to the plan and award agreements as well.

**Additional Considerations**

In addition to these well publicized considerations, we wish to point out several other technical and administrative issues that should be considered before implementing such a program. These factors include tax withholding, administration, and international compliance.

One of the nice things about traditional options is that tax withholding is easily accomplished. In most cases, the employee uses a sell-to-cover or a cashless, sell-all method of exercise to provide not only the exercise price for the exercise of the option but also any necessary tax withholding. Because withholding is satisfied through a market sale, and not through share withholding by the company, there is no problem with the accounting treatment if the company chooses to withhold at a flat rate and true up any over-withholding through payroll. Unfortunately, FAS 123R requires minimum statutory withholding in a situation in which there are net-settled options or net share withholding, such as for restricted stock units. In some cases, there may be a minimum statutory rate applicable in the U.S. (although even in the U.S., the rates will fluctuate by state and by FICA status, so in most cases there is no absolute flat rate even in the U.S.), but there is no flat statutory rate outside the U.S. Companies have struggled to find an appropriate way to accomplish withholding without creating liability accounting.

The administrative issues presented by net-settled options are also more difficult than restricted stock units since units have specified vesting dates. The timing of the withholding and tax calculations is known in advance and often only occurs once per year or perhaps once per quarter. In the case of options, which can be exercised at any time after vesting, the ability to apply the appropriate statutory withholding rates and to accomplish the payroll deposits in a timely fashion proves very difficult. Since there is no market transaction, it seems unlikely that the company will be able to use the T plus 4 timing of payroll deposits permitted for cashless exercise through a market transaction. This will further compress the timing of handling the withholding and deposit in the U.S., and make the necessary withholding approach internationally extremely problematic.

In addition to tax withholding considerations, there will likely be an adverse cash flow impact, because most companies and participants will accomplish withholding through additional net share withholding, with the company providing the cash for the withholding.

Even rounding issues can present problems. If a company rounds up the shares withheld and provides a true up through cash, then the administrative systems in each payroll by country are required to transmit the cash appropriately. In some cases, these global programs have no cash handled by the local company, and as a result this would have to be dealt with manually or under a special procedure.
Another set of issues relates to the existence of appropriate administrative systems to accomplish net-settled option exercises. Brokers and other administrators have long dealt with traditional stock option exercises and have administrative systems in place to permit online exercises and relatively streamlined exercise and administration processes. As we know, when companies began to move to restricted stock units, there was a need to program and create administrative systems for a share release and settlement on vesting in the restricted stock unit program. Those issues have largely been worked out at this stage, now that restricted stock units have been in the market for several years. At this stage, we are not aware of any brokers or administrators that have systems in place to facilitate net-settled options without substantial additional programming or manual processes. These administration issues are further complicated if the net-settled exercise is optional on the part of the option holder.

Given the likely delay in delivery of shares, there will be issues surrounding the precise taxation of net-settled options. In the case of regular option exercises, the tax reporting rules are clear largely because, on the date of exercise, the full number of shares subject to the option are considered transferred to the employee in the sense that the employee can execute a market transaction that day. In fact, the actual market sale price can be used to calculate the taxable income on the Form W-2 in the U.S. This avoids a capital gain or loss on the same day sale of the shares, although it is true that if there is a brokerage commission, then in theory that should be placed on a Schedule D and treated as capital loss. We suspect that the vast majority of employees do not do this, because they receive no 1099-B from the broker, and simply forego the modest tax benefit that would result from such reporting. The problem with the net-settled options is that we doubt that the administrative systems in place will easily permit the number of net shares to be issued on the exercise of the option to be made available on the date of exercise. If shares are not available until a later date, then this could delay the income tax event and, potentially, the calculation of the taxable gain. A company might take the position that, in delivering the shares, it should be able to benefit from the T plus 3 analysis which permits an employee to be taxed on the value of shares received on day one even though the settlement would not occur for three more days. However, since there is no market transaction, it is not clear that the T plus 3 concept could be imported into this net-settled option analysis.

In addition to these substantial administrative issues, there are a variety of international issues as well. There will likely be a few countries that will not analyze these as options at all, particularly if net settlement is mandatory, but rather treat them as SARs, which could result in some modification of tax treatment. For example, in Canada, there is a tax exemption of 50% of the option gain and a potential tax deferral as well. Although it is possible that this treatment would apply to net-settled options, this is not clear and might have to be confirmed with a tax ruling. In all likelihood, the very favorable tax treatment of French qualified stock options would not apply if net-settled exercise method was made available to the French employees. Further, the recently enacted social security exemption available for options in Italy might not apply to net-settled options unless these were specifically viewed as options, which is not clear at present. Each country in
One essential decision the company would have to make in connection with net-settled options is whether to make it a mandatory or only a permissible method of exercise. If only permissible, then this would multiply the administrative issues due to the differing tax withholding and other approaches required based on the method of exercise. If mandatory, then this will limit its use to options granted in the future which would have the mandatory feature. We do not see how a company would be able to easily restrict outstanding grants to the net-settled approach, particularly so with respect to ISOs.

Further, if a company decides to offer net settlement as only one of several methods of settlement, this reduces the effect net-settled options will have on dilution. Reducing dilution is effective only if there are a significant number of net-settled transactions that reduce the impact on dilution, as compared to typical exercise methods. By offering net settlement to employees as one choice of several settlement vehicles, participants would consistently have to choose net settlement in order to have a substantial effect on dilution.

On the other hand, it could be argued that in a voluntary net settlement scenario, when employees are properly educated they will see the obvious benefits of not having a market transaction to report for taxes, absent a sale of the net shares. In reality, this potential benefit would be offset by the fact that in net settlement, the employee is likely not choosing the price at which he or she executes the transaction — that is, there would be no market or limit order. In most stock plan systems, employees can choose their sale price through a limit order, or even set upper and lower sale price limits. Hence, leaving the transaction price up to the close of the market would likely be perceived as taking away flexibility, not adding to it. As has been proven over time, most plan participants exercise their options when they have a need for a specific amount of net proceeds, so timing of sale will be important to them. In this scenario, it has to be assumed that most participants would prefer the same-day sale method of exercising their options. Comparing net-settled transactions versus sell-to-cover or same-day sale transactions from the participants’ point of view, the lack of a market sale to report and the removal of brokerage fees would have to provide a greater benefit than the ability to choose their sales price and to easily sell the net shares as part of the exercise process.

Also, many stock plan systems have reduced brokerage fees when compared to transactions executed for standard brokerage accounts. If brokerage fees are perceived to be too high with a given provider, then offering a net-settlement vehicle would certainly add value to participants. If the broker/vendor receives no brokerage fees, then of course that may impact either the level of overall services the broker will provide or require the company to pay additional fees.

**Final Comment**

One has only to look at the relatively limited demand for stock-settled SARs to see that net-settled option programs may be useful, but should be considered carefully before
implementing. There are few discernable differences between stock-settled SARs and a mandatory net-settled option program; so it is not clear that net-settled options will be any more of a popular program than stock-settled SARs have been to date.

Probably the biggest trend we are seeing is the shift away from options altogether in favor of restricted stock units. Net-settled options are subject to many of the same concerns that have led companies to shift from options to restricted stock units. For example, in the August 25, 2008 issue of Financial Week, there was a lead article entitled, “Glub, Glub, Glub: 40% of Options are under Water”. That article was written when the DOW was above 10,000, so the percentage of underwater options has no doubt increased substantially. The longer that the essentially flat or down market persists, the more companies will have either underwater or barely in the money options, which is likely to lead to an even greater shift to restricted stock unit programs.