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1 hot issues

stock options “underwater”

In today’s turbulent markets, with share prices dropping rapidly, should employee stock options that are “underwater” be re-priced, as the current market share price is now trading at a significant discount than their strike-price (also known as the exercise price)?

Firstly, what is a stock option? An **employee stock option (ESO)** is granted to specified employees of a company and carry the right, but not the obligation, to receive a certain amount of shares in the company at a predetermined price. An ESO is slightly different from a regular exchange-traded option because it is not traded on an exchange, and there is no put component. In addition, employees typically must wait a specified vesting period before being allowed to exercise the option.

The theory is that ESOs align themselves with the incentives of the employees and the shareholders of the Company. Shareholders would like to see the share price go up, so rewarding employees when the stock goes up, should in theory ensure that everyone is striving for the same goals. The ESOs are issued with a strike price, which when the holding period (or vesting period) is over and the stock has appreciated higher than the strike price, then the holder can exercise their options. When the stock goes down, and the market price is below the strike price of the stock (or “underwater”), the holder of the stock would lose the opportunity for a bonus in the short-term.

Therefore, the question arises, in this scenario should management “re-price” the stock options, so that insiders and employees will have a gain?

From an outsider’s point of view, it does not look “good” if a company’s share price is not doing well, and management has to re-issue their options at a new price. Therefore, another idea might be to cancel previously issued options (as the strike price was too high) and re-issue them at a lower price. What is the best route to go?

From a Canadian regulatory point of view, here are some things to consider:

- 1) Stock options held by insiders (see definition of Insider from the Ontario Securities Act Chapter S.5) repricings will always **require shareholder approval at the next annual meeting** (TSX Manual s. 613(h) (iii)).
- 2) Non-insider repricings may be completed without shareholder approval provided that such an amendment is permitted under the company’s ESO plan. This should be carefully checked to make sure this is permitted. Disclosure is required in the next set of annual materials for any amendments which have been made to options. Refer to TSX Staff Notice: 2006-0001.
- 3) Stock option repricings must always be at a price at or above the current market at the time of the repricing (s. 613(h) (i))
- 4) A cancellation and a regrant will be considered a repricing if the two occur within 3 months of each other. TSX Staff Notice: 2006-0004.

For the TSX Manual and staff notices (on www.tsx.com and the direct link is http://tsx.complinet.com/en/display/display.html?bid=2072&element_id=467)

SUBSECTION 613(h) (iii): AMENDMENTS TO NON-INSIDER OPTIONS / ENTITLEMENTS – MORE DETAILS

Section 613(h)(iii) of the Manual requires security holder approval, **excluding the votes of securities held by insiders** benefiting from the amendment, for a reduction in the exercise price or purchase price, or an extension to the term, of any options / entitlements, or similar securities (collectively, “options”), held by **insiders**. As provided for in Staff Notice 2005-0001, if an issuer cancels options held by **insiders** and then regrants those options under different terms, TSX will consider this an amendment which will require security holder approval, unless the regrant occurs at least three months after the related cancellation.

TSX staff remind issuers that for amendments to options held by **non-insiders**, security holder approval will be required unless the security-based compensation arrangement specifically provides that the issuer may so amend options held by non-insiders. If an issuer cancels options held by non-insiders and then regrants those options under different terms, TSX will also consider this an amendment which will require security holder approval, unless the regrant occurs at least three months after the related cancellation, or unless the issuer’s security based compensation arrangement permits the specific amendment to be made without security holder approval.

What are the PROS and CONS of the various options...

ESO are one of the key elements of a compensation package and are very important for employee retention. However, the effectiveness of options for retention can decrease substantially if the option sinks underwater.

The strategy of repricing underwater options has (along with the larger issue of stock option-based compensation) generated significant controversy. Many observers argue that a company's financial results are the responsibility of its management and employees, and that they shouldn't be shielded from the consequences of poor performance.

Companies, however, characterize such action as an investment in the long-term health of the enterprise, saying repricing is necessary to **retain talented employees during lean times**. Some compensation consultants have estimated the costs of employee turnover—which include termination costs, vacancy costs until a job is filled, costs of hiring and training a replacement, and lost productivity with a new employee—at 50% to 200% of an employee's annual salary. Therefore, repricing the options reduces the cost of employee turnover.

It can be argued that there can be some positive and significant stock returns surrounding repricing announcements, that seem to be motivated by the desire to restore incentives and retain employees. In other words, when everyone gets a corporate life jacket, more employees tend to stay on board and the company's bottom line may be revitalized. Then repricing may indeed be beneficial to shareholders and the market will react favourably for reasons of employee retention and incentive realignment.

Repricing Alternatives		
Alternative	Pros	Cons
1. Immediately Reprice Current Underwater Options	<ul style="list-style-type: none"> reduces dilutive effect of issuing more options increases employee retention and morale for non-executive employees and insiders saves company money due to reduced costs associated with employee turnover 	<ul style="list-style-type: none"> institutional holders generally oppose because in their opinion it rewards poor performance proxy disclosure for insiders, check if plan allows for non-executive employees increased accounting expense
2. Accelerate next option grant at lower exercise price	<ul style="list-style-type: none"> increases employee retention and morale for non-executive employees and insiders Avoids adverse accounting expense of repricing current options 	<ul style="list-style-type: none"> increases dilution and stock option overhang must check current Stock Option Plan to see if it allows for additional share grants earlier than outlined in a schedule results in "double-dipping" for employees if share price rebounds institutional holders generally oppose because in their opinion it rewards poor performance
3. Replace underwater options (3 months and 1 day – TSX Rules) after cancellation with a new stock options	<ul style="list-style-type: none"> avoids adverse accounting expense of repricing current options increases employee retention and morale reduces dilutive effect of issuing more options 	<ul style="list-style-type: none"> institutional holders generally oppose because in their opinion it rewards poor performance
4. Buyout of options with cash at some percent of option's value (i.e. employee receives \$ equal to Black-Scholes value of Option)	<ul style="list-style-type: none"> increases employee retention and morale for non-executive employees and insiders 	<ul style="list-style-type: none"> must wait 3 months and 1 day to make subsequent option grant to avoid option expense cash expense to purchase underwater stock
5. Replace options with Restricted Stock	<ul style="list-style-type: none"> increases employee retention and morale for non-executive employees and insiders reduces dilutive effect in the short-term until the restricted stock vests 	<ul style="list-style-type: none"> there will be accounting expenses as restricted stock vests
6. Purchase of underwater options by unrelated third party	<ul style="list-style-type: none"> increases employee retention and morale for non-executive employees and insiders in theory it avoids the accounting expense if it is an arms-length transaction allows grant of new options 	<ul style="list-style-type: none"> adds a new class of shareholders dilution and stock option overhang does not apply to stock options that are "non-transferable"
7. Exchange previously granted stock options for a reduced number of options at a lower price	<ul style="list-style-type: none"> increases employee retention and morale for non-executive employees and insiders reduces the dilutive effect of issuing more options accounting expense is minimized 	<ul style="list-style-type: none"> institutional holders generally oppose because in their opinion it rewards poor performance
8. Issue more stock options at a lower price	<ul style="list-style-type: none"> increases employee retention and morale for non-executive employees and insiders 	<ul style="list-style-type: none"> increases dilution and stock option overhang institutional holders generally oppose because in their opinion it rewards poor performance increased accounting expense

New Executive Compensation Rules effective after December 31, 2008

On September 18, 2008, the CSA published its final rule regarding the repeal and substitution of the current executive compensation disclosure form, also known as Form 51-102F6 (the Current Form). Under this rule, a revised Form 51-102F6 (the New Form) will be implemented, significantly changing current requirements with respect to disclosure of executive compensation and related matters.

The New Form introduces significant changes to the executive and director compensation disclosure requirements from those set out in the Current Form. As currently stated by the CSA, they expect this disclosure to apply in respect of financial years ending on or after **December 31, 2008**.

Overview

The New Form has been organized into a number of new sections with the New Form containing expanded disclosure requirements. The New Form introduces a requirement for a narrative discussion in the form of a “compensation discussion and analysis” (CD&A) and a revised format for the summary compensation table, which includes a column that sets out the dollar value of total compensation as a single number. A new disclosure section for compensation paid to directors is also included. Disclosure of compensation paid under **incentive plans** has also been consolidated into one section, which contains significantly revised requirements for the format of the various tables and explanatory disclosure. This includes the requirement to disclose **equity-based compensation** based on grant date fair value of the grant or award. Other significant changes include expanded pension disclosure and more detailed disclosure on termination or change of control payments. The instructions contained in the New Form state that the objective of the disclosure is to “communicate the compensation the board of directors intended the company to pay, make payable, award, grant, give or otherwise provide to each named executive officer (NEO) and director for the financial year” and that a company’s disclosure under the form must satisfy this objective.

Summary compensation table

The New Form introduces a revised format and additional content for the summary compensation table (the SCT) for the Company’s NEOs.

Under the New Form, identifying the three most highly compensated executive officers is not just based on salary and bonus, but on total compensation (excluding pension value and certain incremental payments as well as some other prescribed exclusions). This effectively means that, in order to make this determination, the company will need to calculate the value of total compensation under the last column of the SCT for its highest paid executives, including the value of equity and non-equity incentive plan awards.

Another significant change in the New Form is the overhaul of the SCT. Under the New Form, the SCT requires disclosure of each **NEO’s salary, share-based awards, option-based awards, non-equity incentive plan compensation** (separated between annual and long-term plans), pension value (as discussed below), **all other compensation** and total compensation for the three most recently completed financial years (recognizing, that a three year history in compliance with the new requirements cannot be presented until 2010). Some of these columns are not only new, but also represent significant changes to what is, or is not, to be included.

For example, the salary column requires the disclosure of the dollar value of cash and non-cash based salary that was earned by an NEO during the relevant financial year. As well, for both share-based awards and option-based awards, the value disclosed must be the grant date fair value. If the grant date fair value is different from the accounting fair value as determined in accordance with section 3870 of the CICA Handbook, footnote disclosure is required disclosing the amount, and an explanation, of the difference. The non-equity incentive plan compensation column requires disclosure of all amounts earned for services performed during the relevant year that are related to awards under non-equity incentive plans and all earnings on any such outstanding awards. This column is to include any discretionary cash awards, earnings, payments, or payables that were not based on pre-determined performance goals as well as performance-based plan awards. This category is divided into two subcategories, (i) annual incentive plans (AIPs) and (ii) long-term incentive plans (LTIPs).

The Pension Value column requires disclosure of all compensation relating to defined benefit or defined contribution plans, including disclosure relating to service costs and other compensatory items.