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Managing a Stock Plan Restructuring

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Agenda

- What is a Restructuring?
- Why Restructure?
- Types of Restructurings
- Examples of Restructurings
- Impact of Restructuring
 - Securities Law
 - Accounting
 - Tax Compliance
 - Global Plan Considerations



Agenda

- In-depth Example – Transferable Stock Options
- Comparative Review
- Restructuring and Plan Administration
- Future



What is a Restructuring?

- A Material Change in the Equity Compensation Practices of a Company – three general categories:
 - An event that requires participant action and/or impacts existing grants or outstanding awards
 - A change in the type or mix of equity compensation vehicles awarded
 - Linkage to a specific event or other corporate performance conditions



Why Restructure?

- **Address Compliance Issues**
 - Accounting Changes – expensing of stock plans
 - Securities Law, Tax and/or other regulatory issues
 - Globalization of plan and country practices – tax efficiency, etc.
- **Address “Pre-existing” Conditions**
 - ‘Underwater’ issues
 - Exchange of value – intrinsic vs. paper value
- **Change Organizational Culture**
 - Create better linkages of compensation to performance
 - Bring equity compensation practices in line with current realities



Types of Restructurings

- **Events Requiring Participant Action**
 - Exchange offers
 - Option repricing
 - “6 & 1” programs – old options for new options
 - Exchange of options for restricted stock or RSU’s
 - Tenders or other employee elections
 - Transferable Stock Options (TSO’s)
- **Change in Equity Compensation Practices**
 - New types of awards – RSU’s, Stock settled SAR’s, etc.
 - Change in mix or eligibility of awards
 - Change in conditions of awards – holding periods, vesting periods, premium-priced grants
- **Linked to a Corporate Event or Factor**
 - Corporate reorganization
 - Performance based plans

Examples – Participant Action Required

- Exchange Offers for existing grants/awards:
 - Typically one-time events
 - Address the ‘underwater’ grant issue
 - Option Repricing offers
 - less favorable due to variable accounting & shareholder issues
 - Traditional “6 & 1” programs
 - cancel existing options and issue new ones at least six months and a day later
 - similar concerns from institutional investors
 - Offer to exchange outstanding options for restricted grants/units or other equity/cash, etc.
 - have become more popular and are not perceived as negatively by the ‘street’
 - restricted grants viewed more as a retention tool than options

Examples – Participant Action Required

- Tenders or other employee elections
 - Tender related to an exchange or other offer
 - typically a formal (SEC-filed) tender offer in support of an exchange program
 - Employee election relating to a range or type of awards
 - example of an employee choosing to receive a portion (or all) of their award in options, restricted, etc.
 - may be one time or on-going

Examples – Participant Action Required

- Transferable Stock Options - TSO
 - A Transferable Stock Option (“TSO”) is an employee stock option that may be sold to a designated third party financial institution for cash after it has vested
 - Two main applications
 - One-time TSO program (e.g. Microsoft transaction)
 - On-going TSO program

Examples – Change in Equity Practices

- New types of awards
 - RSU's - restricted stock units
 - More flexible than traditional restricted grants
 - No shares outstanding until vesting
 - Can eliminate foreign ownership conflicts & tax
 - Potential dividend equivalent issues vs. traditional RSA's
 - Stock-settled SAR's (stock appreciation rights)
 - Receive shares in consideration of price appreciation
 - “Capped” Options
 - Cap or limit maximum gain to be realized
 - Limits expense exposure
 - Premium-priced options
 - Grant price above the fair market value
 - Longer-term view of realization of gain/benefit

Examples – Change in Equity Practices

- Change in mix of awards
 - Complete switch to Restricted stock or RSU's
 - less dilutive
 - more oriented toward retention
 - always 'in the money'
 - expensing easier to manage
 - Grant less options and more restricted
 - limit option grants to most senior levels
 - possible precursor to more fundamental plan change(s)
 - Utilize cash awards over equity compensation

Examples – Change in Equity Practices

- Change in conditions of awards or plans
 - Eliminate option reload feature
 - typically 'paid-out'
 - reduce future expense considerations
 - Require share holding periods
 - require post-exercise retention of shares
 - link to ownership guidelines
 - Restrict exercise choices
 - eliminate or restrict cashless exercises
 - only cash, swaps or sell-to-cover exercises

Examples – Change in Equity Practices

- Change in conditions of awards or plans
 - Modify term of grant
 - reduce years to expiry > reduce expense
 - Modify vesting periods
 - link to performance or other metrics vs. time elapsed
 - Introduce possible forfeiture if metrics not met
 - Utilize premium-priced grants
 - Eliminate/modify discounted ESPP's
 - reduce discount
 - eliminate 'look-back' feature
 - change to non-qualified 'match' plan

Examples – Linked to Corporate Events or Factors

- Corporate Reorganization
 - Plan changes due to:
 - Mergers
 - Spin-offs
 - Bankruptcy/corporate restructuring
 - Negotiated or other benefit/employment agreements
- Performance based plans
 - Awards linked to individual/corporate performance
 - Becoming increasingly common
 - Can be tied to individual or corporate performance metrics



Impact of Restructuring

- Legal – Securities Law Issues
- Accounting Issues
- Tax Compliance
- Global Plan Choices



Impact - Securities Law Issues

- Two separate dimensions
 - Home country securities laws--where the parent company is located
 - “Foreign” securities laws--where employees are located
- Consider the US as an example for each dimension
 - First, a US public company restructuring a global program
 - Second, a non-US company restructuring its program for US employees



An Example of Domestic Securities Laws

- Impact on a restructuring requiring employee action
 - Compliance with tender offer regulations
 - Possible shareholder approval
- Typical US public company
 - Common shares traded on NYSE or NASDAQ
 - Registered with the Securities and Exchange Commission
 - Eligible to use Form S-8, the simplified form for sale of shares to employees



US Domestic Securities Laws

- Employee tender/exchange offers must comply with procedural and substantive requirements
- Filing of Form TO with the SEC
 - Must describe the terms of the offer in detail
 - SEC reviews and comments on the filing
- Offer must be open at least 20 business days
- Relief available from “best-price” and “all-holders” rules

US Domestic Securities Laws

- Initial dissemination of Form TO to employees starts the 20-day clock
- SEC typically reviews and comments within 5-7 business days
- If no major problems, final Form TO is filed without re-starting the clock
- Bifurcation of non-US employees is discouraged

US Domestic Securities Laws

- Additional SEC considerations for “transfer” programs
 - Market sales by third-party bankers must be separately registered
 - Form S-3 Prospectus describes the “Plan of Distribution”
 - Recent “no-action letters” address additional technical issues, including impact of hedging arrangements on Rule 144 sales

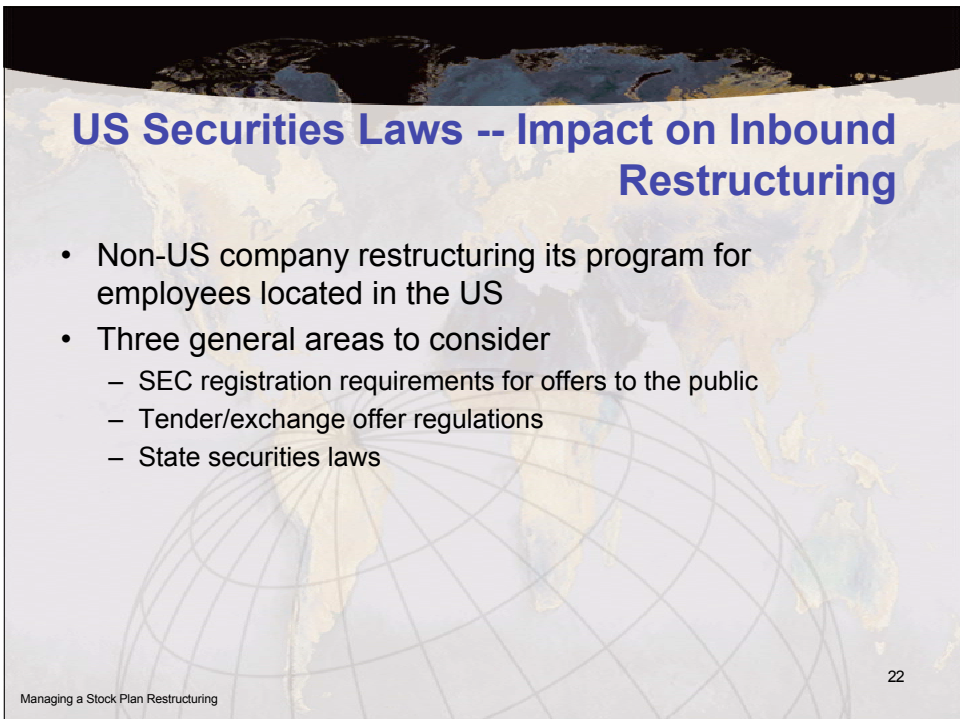


US Domestic Securities Laws

- Shareholder approval required for some restructurings
- Plan document may require approval of “repricings”
 - Application of plan language often uncertain
 - NYSE and NASDAQ now require approval of repricings
 - Rules are not the same, and both have quirks
- Transfer programs could be considered repricings, but practice is still developing
 - Plan language must also permit transferable awards, which many do not

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US Securities Laws -- Impact on Inbound Restructuring

- Non-US company restructuring its program for employees located in the US
- Three general areas to consider
 - SEC registration requirements for offers to the public
 - Tender/exchange offer regulations
 - State securities laws

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US Securities Laws--Impact on Inbound Restructuring

- Compliance regime depends on SEC registration status
- Fully registered “foreign private issuers” follow the pattern for US domestic companies
 - Exceptions for cross-border offers where US holders own less than 10 %
 - Possibility of bifurcation so US participants stand alone
 - Exceptions for Canadian companies with less than 40% US ownership

US Securities Laws--Impact on Inbound Restructuring

- Non-US companies that are not registered with the SEC follow a different regulatory pattern
 - Filing of Form TO not required
 - Anti-fraud rules still apply, including 20-day minimum offering period
 - Customary practice is to deliver comparable documentation to participants, even though filing is not required

Impact of Restructuring - Accounting

- Accounting Issues
 - FASB / IASB - Equity Plan Expense considerations
 - Analyze and understand the impact on your company's earnings and earnings per share
 - FAS 123 Valuation – fair value measurement/models/inputs
 - Fixed vs. Variable treatment of plans
 - Requirement to expense options removes historic “advantages” of using options vs. other equity awards

Impact of Restructuring - Tax

- Tax Compliance – Implications are driven by the type of equity vehicle and specific award conditions
 - Implications to participant
 - Timing of taxation
 - Character of income/tax rates
 - Implications to company
 - Reporting requirements
 - Income/social tax withholding requirements
 - Corporate tax deduction related to “compensation”



Impact of Restructuring – Tax

- Considerations for plan changes
 - Exchange offers/tender or other employee elections
 - Structure to avoid taxation (US and non-US); more common to run into difficulties in non-US locations
 - Implications for awards offered under “qualified plans” or rulings
 - Implications for awards previously taxed in non-US jurisdictions
 - Shift to use of RSA’s/RSU’s
 - Provides for flexibility in award design to maximize beneficial tax treatment
 - Consider continued use of Stock Options
 - Certain non-US jurisdictions provide favorable treatment for “qualified” options which are not available for RSA’s/RSU’s



Impact of Restructuring – Global

- Global Plan Choices
 - Certain plan changes can greatly facilitate the use of certain awards in certain jurisdictions
 - Use restructuring as an opportunity to conduct due diligence in non-US jurisdictions to structure awards
 - Need to strike the balance between plan objectives and implementation requirements
 - Review country specific requirements before rolling out to ensure it is practical
 - Consider additional work required to implement changes globally
 - Substantially more work
 - Timing – holidays/vacations/civil unrest....



In-depth Example – Transferable Stock Options – TSO's

- A Transferable Stock Option (“TSO”) is an employee stock option that may be sold to a designated third party financial institution for cash after it has vested
- Two main applications
 - One-time TSO program (e.g. Microsoft transaction)
 - On-going TSO program



Example of a one-time TSO program

- Microsoft announced program in July; completed December 11, 2003
- Offered to employees in over 70 countries
- Eligible options: strikes ≥ 33 ; all or none
- Microsoft truncated transferred options to 2 or 3 year term
 - Reduce the potential dilution and share benefits with shareholders
- Portion of proceeds was deferred over a 2 or 3 year vesting period
 - Enhance employee retention
- Program results (see SEC filings for more details)
 - 51% employee participation rate; 55% of eligible options sold
 - JPMorgan paid \$382 million for transferred options
 - Microsoft receives approx \$400 million in tax deductions

Shareholder considerations

- One-time TSO program can be structured to share benefits between employees and shareholders
 - Company must assess how much value can be returned to shareholders while keeping program attractive for employees
 - Shareholder approval may be required
 - Companies should consider engaging with ISS and significant shareholders prior to implementation

Sharing benefits with shareholders

- Consider an employee (John Doe) with 3,000 underwater options. Current stock price = \$35; Strike = \$60; Remaining Term = 6 years; Expected Life = 5 years.

Company cost prior to program (expected term of 5 years)	\$4.46 per option (Total = \$13,380)		Difference = \$7,080 → Shareholder value created	
Company cost after program (truncated to 3-year term)	\$2.10 per option (Total = \$6,300)			Difference = \$3,150 → Retention benefit
Cash John Doe receives upfront	\$1.05 per option (Total = \$3,150)			Difference = \$3,150 → Value created for John Doe upfront
John's valuation prior to program	\$0			

- Pricing assumptions: 30% volatility; 1% dividend yield; market interest rates

Benefits / issues to consider

Benefits

- No need to use company cash or issue new potentially dilutive securities
- Deferral increases retention
- Reduced potential dilution through truncation or share reduction
- Company gets tax deduction

Issues to Consider

- Requires regulatory review and filing (like other tender / exchange offers)
- Shareholder communication is important

Accounting Issues for one-time TSO (US)

- Accounting (FAS 123)
 - Modifications accounted for as exchange of original for modified award.
 - Incremental compensation cost is:
 - $FV(\text{new award}) - FV^*(\text{original award})$
 - Can be structured so that transferability does not create additional compensation expense

Tax Issues for one-time TSO (US)

- Tax
 - Employee is taxed at time proceeds are received
 - Company gets tax deduction when proceeds received
 - Eligible options not tendered do not trigger taxes
 - Section 83
 - Limited transferability to a designated third party does not lead to “readily ascertainable fair market value”
 - Section 162 (m)
 - Company subject to 162(m) for top 5 executives
 - Potential solutions

Some International Tax Considerations

- TSO tax consequences to employees and employer differ by jurisdiction
 - Company will need to review tax rules for transferability in all jurisdictions and modify program accordingly. Example, for Canada
 - Full option proceeds taxable upon sale regardless of deferral. Company can modify program to give employees enough proceeds upfront to cover taxes.
 - Program will have to be structured as a two-step process to ensure that employer gets tax deduction

Restructuring Example – On-going TSO

- Some concerns with traditional employee stock options:
 - Inefficiency: value gap
 - “Fragility”: ESOs can fall underwater and lose incentive power
- An on-going TSO program can address these concerns
 - TSOs are more valuable than ESOs
 - TSOs provide “price x quantity” transparency
 - TSOs will always have a value even when underwater
- Variations of on-going TSO programs
 - Transferable premium options
 - Transferable index options
 - TSOs with transferability rights linked to performance

TSOs provide simple “PxQ” transparency

- Sample account statement for employee with TSOs

Options currently exercisable						Grant Options held by employee		Years to maturity	Exercise price	Intrinsic value

Comparative Review

Type of Restructuring	Issues Addressed	Impact
Exchange of Options - Option Repricing - “6 & 1” Programs - Exchange for RSAs/RSUs	Underwater options	Unattractive Accounting & Shareholder Issues
	Underwater & Accounting	Shareholder Issues & Dilutive
	Underwater & Dilution	Less dilutive, better received – retention oriented
Employee Elections	Empower employees – give control over choice of awards	Improved Morale
Transferable Stock Options	Underwater, Dilution, contain potential expense impact	Exchange of Value, can be less dilutive & limit expense impact
New Award types - RSU’s - Stock-Settled SAR’s - “Capped” Options - Premium-priced Options	No initial ownership Shares not outstanding	Facilitates foreign grants/usage May require dividend equivalents
	Traditional SARs – cash comp Accounting treatment	Promotes ownership Accounting to be resolved
	Limit expense potential	Difficult to administer
	Limit expense potential	Focus on long-term appreciation

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Comparative Review

Type of Restructuring	Issues Addressed	Impact
Change in Mix of Awards - Switch to all Restricted - Less Options, more RSA’s or RSU’s - Utilize Cash	Underwater & Dilution	Always in the money, Lower burn rate, Long-term orientation
	Underwater & Dilution	Trend toward less Dilution, less upside potential for employees
	Underwater & Dilution	Not dilutive, however, questionable use of capital
Change in Award Conditions - Require holding periods - Restrict exercise types - Reduce grant term - Change ESPP’s	Long-term ownership	Diversification & liquidity
	Long-term ownership	Diversification & liquidity
	Reduce expense potential	Reduce upside potential
	Reduce expense potential	Morale issues & Benefit offset
Linked to other Events/Factors - Corporate Reorganizations - Performance based plans	Multiple issues – case specific	Administration of changes
	Linking Equity Compensation to Performance	Administering performance triggers vis-à-vis plan metrics

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Restructuring and Plan Administration

- Key Questions:
 - What are the Objectives?
 - Employee demographics
 - Age, turnover rate, etc.
 - Recruitment vs. retention
 - Investor considerations
 - Shareholder approval, etc.
 - Peer/Industry considerations
 - Competitor practices
 - What are my Choices?
 - No one-size-fits-all approach
 - Consider all alternatives

Restructuring and Plan Administration

- Key Questions:
 - Practical Considerations
 - Available resources vs. design objectives
 - Timing of change - rollout
 - Cultural considerations
 - Transactional support
 - Company checklist
 - Global perspective
 - Communication issues



The Future

- **Alternative Equity Vehicles**
 - Many hybrid or alternative means of delivering equity compensation are likely to continue to be developed to meet the global spectrum of company/plan objectives
- **Equity Compensation and Plans will continue to change**
 - Regulatory environments will continue to be the most significant driver of new plan design and alternative considerations
 - It is important to consider the impact that design objectives and regulatory considerations will have on the actual practice of plan administration – while some features and vehicles may have merit ‘on paper’, they may in fact be very difficult or impossible to reasonably administer

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Any Questions?

Thank You

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