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Black-Scholes value may not equate to a 50% drop in the perceived value. We're not sure the same can be said for restricted stock.

Regardless of the approach used to determine grant sizes, we expect that companies will have to find an acceptable compromise between an acceptable burn rate and making sure grants are still meaningful to employees.

Aggregate Limit on Shares Granted

Another approach is to set an aggregate limit on the total number of shares the company will grant during the year. This limit could be simply the same number of shares the company granted last year or could be designed to maintain the same burn rate.

Once the aggregate limit is determined, individual grants are allocated to employees in accordance with this limit. One way to do this would be similar to the way a share shortfall in an ESPP is handled (see our January-February 2009 issue at pg 7): determine individual grant sizes without regard to the limit, and then prorate all grants commensurately to stay under the limit. For example, if the total number of shares that would be granted without regard to the limit is 500,000 and the aggregate limit is 400,000 shares, all employee grants would be reduced by 10%.

Companies often make individual allocations from the overall pool based on performance and each employee's value to the organization. This gives the company the flexibility to award shares where they are needed/deserved the most, but, to be most effective, this requires a sound performance management system to ensure an unbiased and accurate method of assessing performance, something many companies struggle with.

Average Value

Towers Perrin suggests that companies "normalize" grants by basing values on the average price over the past year. [For stock options, the number of shares would be based on the Black-Scholes value of an at-the-money option granted at the average price. This wouldn't change the per-share fair value for FAS 123(R) purposes or the option exercise price—those would still be based on the FMV on the actual grant date.] Some companies are experimenting with using rolling three-year average stock prices for grants this year (and all future years) to dampen the effects of rising or declining stock prices.

Different Valuation Assumptions or Model

For stock options, a further approach is to assume different inputs when valuing options for compensation planning purposes than are assumed for 123(R) purposes. There are no legal requirements on how option value must be calculated for compensation planning purposes; companies are not bound to use the 123(R) value. The most obvious input to consider changing is the expected life assumption. (We can't think of any justifiable reason to assume a different expected volatility for compensation planning purposes than is assumed for 123(R) purposes and changing the interest rate or dividend yield assumptions, if there is even a valid reason to do so, is unlikely to have much impact on option values.)

123(R) requires that companies assume an expected life that is equal to the length of time the option is expected to be outstanding, *i.e.*, the period from grant until the option is exercised, cancelled, or expires. But where companies are granting options with a longer contractual term, is it appropriate to assume this shorter expected life when valuing the options for compensation planning purposes? Shouldn't the company consider the full period over which the option could pay out, *i.e.*, the contractual term, when determining the value for compensation purposes? After all, the decision to exercise earlier than the contractual term is the executive's; if a period shorter than the contractual term is assumed for valuation purposes, executives receive more shares in future grants when they choose to exercise their existing grants earlier.

Assuming a longer expected life will increase the option fair value. In our earlier example of an option with an assumed expected life of five years, increasing this to ten years increases the option fair value by somewhere around 40% (actual percentage of the increase in fair value may vary depending on the other assumptions, particularly expected volatility—in our example, we assumed 40% expected volatility).

By the same token, where companies are using lattice or other more sophisticated models to value service-based stock options, we wonder if it would make sense to stick with Black-Scholes for compensation planning purposes. (Black-Scholes is the clear winner here anyway, with 74% of respondents in the Buck Consultants survey indicating that this is the model used.)

The advantage of lattice models, as they are applied to employee stock options, is that they reduce option fair value based on the likelihood of exercise prior to the end of the contractual term due to either an increase in stock prices or termination of employment. But when assessing the value of the option in relation to an executives' overall compensation package, we question whether it is appropriate for the value to anticipate either of these two events.

Anticipated Payout

It is also worthwhile to consider what the awards might be worth in the future, assuming the company's stock price recovers. Consider several different future price paths for the company's stock—say, pessimistic, moderate, and optimistic paths—and estimate what the award will be worth over the next several years and upon payout. [Don't do this at home, kids. For this analysis to be meaningful, you have to assume realistic price paths for the stock. If you don't have experience with predicting future stock price growth, get help from someone who does.]

While we wouldn't recommend relying solely on this approach for determining grant sizes; it works well as a check and balance to the other approaches, both as a means of avoiding overcompensation if the stock price recovers and ensuring that awards are meaningful to employees. We understand that some Compensation Committees have valued options and stock awards based on a target price, say $12, when the stock is trading at $3. Participants are being told they will only be able to earn a market rate of LTI if the stock attains $12. Thus, stock options, for this purpose, are being valued at $9 and restricted stock at $12.

A Feature Worthy of Serious Consideration. Given the windfalls executives could realize if the stock market recovers, we think that now might be a good time to revisit the idea of capping option gains (see our September-October 2005 issue at pg 5). A cap of two or three times the option price seems like a reasonable level of compensation (for companies where Black-Scholes value is 50% of their stock price—many companies these days—this is a gain of four to six times the grant date fair value of an uncapped option). An added benefit here might be that the cap could help minimize the impact that sky-rocketing expected volatilities are having on option expense. [It is not too late for companies that have already made grants to go back to the top tier of executives and require them to agree to this feature. This is not unlike the CEO going back to those same executives and having them agree to a hold-through-retirement provision. The CEO can point out that this is still very generous and will help restore the shareholders' trust in the company's leadership.]

Reduce Plan Participation

We also expect that some companies will choose to reduce plan participation as an alternative to reducing grant sizes. The previously mentioned survey by Buck Consultants reports, in contrast to the Towers Perrin and Exequity surveys, that companies that determine grant sizes based on value are not anticipating reducing grant values in 2009 (70% of respondents with a value-based grant approach indicated that they did not anticipate changing grant practices for 2009). The survey results further indicated that these companies expect to increase the number of shares granted in consequence.

[The survey did indicate that 60% of respondents that base grant sizes on the number of shares granted did not anticipate changing their grant practices in 2009. For these companies, grant values will decline if their stock price has declined, thus the survey is not in complete disagreement with the Towers Perrin and Exequity surveys.]

Buck Consultants found that 43% of respondents expected to decrease plan participation. This makes sense—if more shares are granted from a limited reserve, then fewer employees will get to participate. We are disheartened to see companies take this approach as we expect that, with rare exceptions, the eliminated participants are rank and file. Thus, this approach concentrates more shares in the hands of top executives, eroding the motivation of those left out. But, if used in conjunction with a strategy to deliver equity to rank-and-file employees in another way—such as an ESPP (see our article on replacing a broad-based stock option program with an ESPP in our January-February 2007 issue at pg 1), this could be a commendable strategy.

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More Shares, Please

When all else fails, there is always the alternative of asking shareholders to approve more shares for the plan. In a quick survey conducted by the NASPP in March, 34% of respondents that were concerned about a plan shortfall or burn rates indicated they would be asking shareholders to approve an additional allocation of shares to their plan. It will be interesting to compare the number of these requests and the resultant votes in this year's proxy season to prior years.

All of the Above

There is no reason companies should be limited to just one of these approaches; many companies may find a combination of approaches to be more effective. For example, the reduced value approach might be combined with using an average share price or using a different valuation method for stock options. And, regardless of what method is used to determine grant sizes, estimating future payouts (and tracking actual outcomes) is a critical analysis that should be presented to all compensation committees.

A Reason to Stick with Stock Options

In periods of market instability like this, we often hear restricted stock and units touted as a better alternative than stock options because they can never be underwater. But given some of the challenges involved in determining grant sizes when stock prices are depressed, we can see a number of advantages that stock options offer over restricted stock and units:

- Because option value is dependent on more than just the stock price, a decline in stock value doesn't always equate to a dollar-for-dollar decline in option fair value.

- Stock options offer greater flexibility in determining award values (*e.g.*, different pricing models, different assumptions for valuation purposes).

- Employees' perceived values for new stock options tend to be high when the stock price is low and low when the stock price is high. Thus, perceived value moves the opposite way of Black-Scholes value.

A period where a company experiences a low stock price, particularly one due to undervaluation or overall market conditions, is a great opportunity to grant stock options. The low exercise price equates to upside potential and, because options are more leveraged than restricted stock or units, *i.e.*, are for a greater number of shares, their potential return is greater than that of restricted stock or units. It might seem contradictory to recommend using an award that requires more shares in an article about minimizing share usage and burn rates, but, due to how institutional investor advisory groups value options vs. restricted stock/units, most companies typically have more shares available for grant as options than they do for restricted stock/units. And if it's good idea to invest in an undervalued stock, it's even better to have an option on it.

Two Fundamental—and Very Relevant—Considerations for High Level Executives

While we're on the topic of grant sizes, we want to remind our readers that it is critical, especially in today's environment, for all those who design plans and advise compensation committees—and for boards—to revisit the purpose of grants to the top tier of executives.

Has a Sufficient Carried Interest Been Reached?

As Fred Cook pointed out in his seminal talk to directors at Stanford (posted on CompensationStandards.com), many of us have gotten away from (and need to return to) the purpose of stock option grants to top tier executives. For the very top executives, the purpose of equity grants is to create a "carried interest," a pot of gold to strive to achieve by the end of a career. Options (and restricted stock) were not intended to be part of annual compensation. Rather, grants were to be made only until the total reached a critical mass that would be the incentive to create real long term value for the company and its shareholders and, ultimately, the executive.

As Fred Cook and other respected authorities have pointed out, many CEOs and NEOs today already have accumulated so much wealth largely through grants that have become annualized (instead of stopping once a substantial amount has been reached) that additional incremental grants produce little additional incentive. A reality check here is to realize that grants to CEOs have gotten so far away from their purpose that

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today's typical CEO annual grant is more than two times what was considered a one-time, huge head-turning mega-grant 20 years ago (see the special supplement to the September-October 2006 issue of *The Corporate Counsel* at pg 1).

It may well be appropriate at this time for compensation committees and CEOs—and those of us who serve as advisers—to speak frankly and openly and return to the fundamental purpose of equity grants. Particularly for the top tier of executives, we each must question not only any increase in the number of shares granted, but also whether the CEO may have already reached a critical mass so that additional grants are inappropriate. (Companies can leverage this into a positive message to shareholders, pointing out that the top executives are not receiving additional grants so that more shares are available to other employees.)

[We know that many executives have experienced large paper reductions in their wealth (as have shareholders), but this is not the time to give in to the temptation of "make-up" or "retention" grants. Right now we are presented with an opportunity to reassess and correct some of the flaws that have been built into our CEO compensation models, particularly with respect to the two areas that have gotten out of line over the years—(i) stock option and restricted stock grants, and (ii) severance and retirement provisions.]

Don't Overlook Hold-Through-Retirement Provisions for Grants to Top Execs

The other important and very timely consideration is to make sure to include in all new grants to top tier executives (as well as previous grants) a hold-through-retirement provision. This will help demonstrate to shareholders that CEOs are committed to, and believe in, the long-term value of the company and will also address the excessive risk assessment issue that companies must now focus on when making stock option grants. (See our November-December 2008 issue and our September-October 2008 issue.)

Executives "Donate" "Mega" Grants Back to the Plan

Where companies are running out of shares in their plan, one strategy we've seen interest in lately is for executives to allow the company to cancel their underwater stock options (or performance shares) for no consideration. We've never liked "mega" grants (*e.g.*, grants equal to or greater than three times an executive's annual compensation—see our May-June 1995 issue at pg 5); with so many underwater these days, now is a great time to get rid of them. The shares underlying the cancelled grants can then once again be available for grant, extending the life of the company's stock plan.

Keynote Systems recently was able to add 700,000 shares back to its stock plan with this strategy. According to its Form 8-K dated March 6, 2009, Keynote's CEO agreed to the cancellation of two options, one for 400,000 shares with an exercise price of $14.99 per share and the other for 300,000 shares with an exercise price of $70 per share (Keynote's stock is currently trading at around $9 per share). The $70 option was granted in 2000, so we expect that it was due to expire next year anyway. The 8-K doesn't specifically say that the purpose was to inject more shares into the plan, but given that the surrender coincides with Keynote's shareholders approving an extension of the option plan (otherwise due to expire this year) and since Keynote was down to less than 400,000 shares available for grant under the extended plan (by way of comparison, Keynote has ten times that number of options outstanding), this seems like a reasonable assumption. We suspect there are executives out there holding similar-sized grants that are also as deeply underwater that might be persuaded to part with them, especially in light of current criticisms of excessive executive compensation.

Because the executive receives no consideration in exchange for the surrendered options, the cancellation should not be considered a repricing under the NYSE or Nasdaq listing requirements (see the accounting discussion below). The transaction doesn't run afoul of the requirements that repricings be subject to shareholder approval (unless specifically permitted under the plan—see our November-December 2008 issue at pg 6).

<u>Net Counting or Gross Counting, Who Cares?</u> We've talked a lot about the pros and cons of net vs. gross counting in the context of net exercises (see our March-April 2008 issue at pg 6) and, for option exchange programs at a less

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than one-for-one ratio, we strongly recommend that the excess shares not be made available for future grants (see our November-December 2008 issue at pg 9). But in this scenario, these concerns don't apply.

This is merely a straight-forward option cancellation, for plan purposes, no different from an option that cancels due to termination of employment or at the expiration of the contractual term. There's no reason why the cancelled shares can't be made available for future grants (although the company would have to be careful about immediately regranting them to the same executive, as that could be considered a repricing in substance). To our knowledge, RiskMetrics (formerly ISS) and other shareholder advisory services have no prohibitions on shares that are cancelled for no consideration being made available for future grants.

No Tender Offer. So long as only a handful of executives are involved in the program, it shouldn't be considered a tender offer. Generally, tender offer compliance is only implicated when a larger group of employees is involved in an offer of value for their securities (see our November-December 2008 issue at pg 5). Even if more than a handful of executives are included, it isn't clear that tender offer compliance is necessary. Since the executives aren't receiving any consideration in exchange for their options, the surrender would not involve a tender offer. However, if there was some link between new grants and the surrendered awards, it is possible that the tender offer rules could be implicated.

Accounting Treatment. Under FAS 123(R), because the executive has voluntarily agreed to the cancellation, it is not considered a forfeiture and there is no reversal of expense for the cancelled shares. Instead, it is viewed as akin to an acceleration of vesting and any remaining unrecognized expense is an immediate hit to earnings. If the option is fully vested, this is less of an issue as it will have already been fully expensed.

There is now no possibility that the executive will recognize taxable income on the option, and consequently, the company forfeits any expectation of a tax deduction. If the option is an NQSO, the company assumed a tax deduction as the option expense was recorded. This assumed tax savings is written off at the time the option is cancelled; this shortfall in expected tax benefits could result in the company recognizing additional tax expense if there isn't sufficient excess paid-in-capital from prior stock plan transactions to absorb the deficiency (see our January-February 2005 issue at pg 1). In the end, this may not be a significant concern however—where the option is underwater, the chances that the company would ever have gotten a tax deduction may be slim anyway.

Companies should work closely with their outside accounting firm on the timing of any new awards to executives who voluntarily surrendered their underwater stock options for no consideration. It is our understanding that the timing—or size—of a new grant could lead accountants to conclude that there was a repricing in substance. It is also our understanding that if it is a repricing for accounting purposes, it may be treated as a repricing by the SEC and the stock exchanges.

Securities Law Considerations. Under Rule 16b-6(d), the cancellation of a stock option for no consideration is exempt from the operation of the Section 16(b) short-swing profits recovery provisions. Rule 16a-4(d) further exempts the cancellation from the Section 16(a) reporting requirements (see Model Form 97 in Romeo & Dye's *2005 Section 16 Forms and Filing Handbook*).

In most cases, we think that the surrender of awards should be reported on Form 8-K. While Keynote Systems reported the CEO's surrender of awards under Item 8.01, it is possible that the awards could be reportable under Item 5.02(e), which requires the current reporting on Form 8-K of material amendments or modifications of compensatory arrangements. In Regulation S-K Compliance and Disclosure Interpretation 117.14, the Staff indicated that "[a] termination should be disclosed if it constitutes a material amendment or modification of the executive compensation plan." The same analysis would also apply for the termination of an award under a plan upon surrender of that award, given that Item 5.02(e) contemplates disclosure when "a material grant or award under any such plan, contract or arrangement to any such person is made or materially modified."

Acceleration of Vesting Under 123(R)—Update

The last time we focused in detail on the accounting treatment of acceleration of vesting was when FAS 123(R) was first going into effect. Companies were looking at accelerating vesting as a way of recognizing all the remaining expense for their underwater options while the expense was still a footnote disclosure item rather than an actual hit to the P&L (*i.e.*, before they adopted 123(R)—see our November-December 2005 issue at pg 1). Back then, the treatment of acceleration of vesting was fairly well-defined under APB Opinion No. 25, but no one had really looked too closely at the FAS 123 or 123(R) treatment. And, although there's no new accounting standard on the immediate horizon to avoid right now (IFRS 2 still appears to be a ways off), the glut of underwater options resulting from today's depressed market conditions has brought this practice back to the forefront. Since we now know a little bit more about the treatment of acceleration of vesting under 123(R), we thought it would be a good time to revisit the topic.

Four Types of Modifications

123(R) defines four types of modifications: (i) probable-to-probable, where the awards were expected to vest before the modification and are still expected to vest afterwards; (ii) probable-to-improbable, where the awards were expected to vest before the modification but are not expected to vest afterwards; (iii) improbable-to-probable, where the awards were not expected to vest prior to the modification but are expected to vest afterwards; and (iv) improbable-to-improbable, where the awards were not expected to vest before the modification and are still not expected to vest afterwards. Acceleration of vesting can be either a type (i) probable-to-probable or a type (iii) improbable-to-probable modification.

Acceleration of Vesting Upon Termination

Acceleration of vesting upon termination will always be a type (iii) improbable-to-probable modification. At the time of termination, the expectation is that the unvested portion of the award will be forfeited. Barring any provision in the plan or award agreement that provides otherwise, and any intercession on the part of the company, unvested awards are certain to be forfeited at termination. In fact, saying that vesting is "improbable" seems to us like a gross understatement, but that's the way accountants talk. By accelerating vesting, the company guarantees that the award will vest. *I.e.*, after the modification, it is (highly) probable that award will vest (yet another understatement), hence the term "improbable-to-probable."

On an improbable-to-probable modification, the company does not recognize expense for the unvested portion of the original award (and reverses previously recognized expense related to this portion of the award, if the company's estimated forfeiture rate did not include the forfeiture that would have occurred absent acceleration). The company recognizes incremental cost for the modified portion of the award to the extent that the current fair value exceeds the fair value just prior to the modification. In this situation, since none of the shares subject to the acceleration were expected to vest prior to the modification, the fair value of the modified portion of the award prior to the modification is $0. Thus, the incremental cost will be the full fair value of the modified portion of the award as computed after the acceleration.

For example, let's assume an option to purchase 20,000 shares with a grant date fair value of $10 per share (an aggregate expense of $200,000), that vests in two equal annual increments. The executive terminates a year and a quarter into the vesting period. At this point, the first vesting tranche has vested and one-quarter of the service period related to the second vesting tranche has elapsed (but this tranche isn't scheduled to vest for another nine months). At the time of the executive's termination, the compensation committee amends the grant to accelerate vesting for the remaining unvested portion of the option (the 10,000 shares in the second vesting tranche). At this time, the fair value of the option has increased to $12 per share.

Since the first 10,000 shares in the option are already vested, they aren't subject to acceleration and there's no change in the expense that the company has already recognized for them (and there's no further expense to recognize either).

The modification is viewed as a cancellation and a regrant of the second vesting tranche. The company will not record the remaining $100,000 of expense related to this tranche (10,000 shares multiplied by grant date fair value of $10 per share). Depending on how accurate the company's forfeiture estimate is, the company may have

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already recognized a portion of this expense; if so, that would be reversed in the period in which the termination occurs.

Up to this point, the accounting treatment is exactly the same as for any other forfeiture upon termination; expense for the vested portion of the award is unchanged and no expense is recognized for the forfeited portion of the award. But, in this case, because accelerating vesting prevents the unvested portion of the award from being forfeited, there is additional incremental cost. As with any modification, the incremental cost is equal to the increase in fair value of the award. Since none of the shares in the second tranche would have vested prior to the acceleration, the fair value of this tranche just prior to the modification is $0. Afterwards, it is $120,000 ($12 current fair value per share multiplied by 10,000 shares). Thus, the company's incremental cost for the modification is $120,000 and the aggregate cost for the option is $220,000 ($100,000 for the first vesting tranche plus the incremental cost for the second vesting tranche).

As the option is now fully vested, the $120,000 of incremental cost is recognized in full in the period the acceleration of vesting is approved.

[A Disclosure Heads-Up. Readers who are responsible for proxy disclosures will want to make sure these amounts are set forth in the disclosures addressing CEO and NEO terminations, etc.]

Without Termination of Employment

Acceleration of vesting at a time when the executive's termination of employment isn't imminent or anticipated involves a type (i) probable-to-probable and a type (iii) improbable-to-probable modification. It is likely that most of the awards subject to the acceleration were expected to vest before the acceleration and are still expected to vest afterwards; for this portion of the awards, the acceleration of vesting is a probable-to-probable modification. In a probable-to-probable modification where only the vesting conditions and no other terms are changed, there is no change in the amount of expense recognized for the award. The only impact is that recognition of all remaining unamortized expenses is accelerated to the period in which the modification is approved.

But some of the awards weren't expected to vest prior to the acceleration. Under 123(R), expense recorded for awards is reduced based on estimated forfeitures (see our March-April 2006 issue at pg 9); for the awards expected to be forfeited, the acceleration of vesting is an improbable-to-probable modification. Here the accounting treatment is the same as for acceleration of vesting upon termination of employment. The fair value originally calculated for these shares is no longer recognized (and, if a portion of the original fair value has already been recognized as expense, that expense may be reversed). A new fair value calculation is performed as of the modification date and that value is recognized as additional expense in the period the modification is approved (since the awards are now fully vested).

For example, say that a company grants options to purchase 500,000 shares that vest over a one-year cliff period and have a grant date fair value of $10 per share. At the time of grant, the company expects that 2% of the awards will be forfeited, thus the expense that will be recorded for the awards over the one-year vesting period is $4,900,000 (98% of $5,000,000). Halfway through the vesting period, the company accelerates vesting on all of the awards. At the time of the acceleration, the fair value of the awards is $12 per share.

At the time the acceleration occurs, the company has already recorded $2,450,000 of expense (50% of $4,900,000). For the 98% of the awards that the company expected to vest, there is no change in the amount of expense recognized, but the remaining $2,450,000 of expense will be recorded immediately in the period the acceleration is approved.

The company will have to recalculate the amount of expense recorded for the 2% of the awards that were not expected to vest. The company does not recognize the $100,000 of expense originally computed for these awards (10,000 shares multiplied by $10 per share); instead, it recognizes expense based on the awards' new fair value, or $120,000 (10,000 shares multiplied by $12 per share). This is also recognized in the period the acceleration is approved, so the aggregate expense recognized in that period is $2,570,000 ($120,000 plus $2,450,000).

Underwater Options

One strategy we've heard mentioned recently is to accelerate vesting of underwater options. The idea is that this would accelerate recognition of

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any remaining expense for options into the current fiscal period (when the company perhaps has no hope of profitability anyway), thus reducing stock option expense for future fiscal periods (making profitability more achievable or clearing the way for new option grants). But, we've learned that this strategy may backfire.

The Deep End of the Pool. Under 123(R), if vesting is accelerated for an option that was granted at FMV at a time when the option is deeply underwater, then the acceleration is considered non-substantive. Although vesting is accelerated, the underwater status of the option effectively prevents the executive from exercising, making the acceleration moot. It's as if the acceleration didn't occur. There is no change whatsoever in the applicable accounting treatment; the company continues to recognize expense for the option just as if there had been no acceleration of vesting (no change in fair value, no change in the period over which expense is recognized).

Worse, if the executive terminates prior to the original vesting dates, since vesting has been accelerated the executive won't forfeit any portion of the option and all remaining expense for the option must still be recognized. (The timing of recognition isn't completely clear and we're not aware of any companies that have done this and had to figure out the answer, but we think that recognition of any remaining expense would likely be accelerated to the period in which the termination occurs.) On the other hand, if vesting hadn't been accelerated, the company would not have to recognize expense for the portion of the option that would have been forfeited. Thus, this strategy doesn't accomplish what the company had intended (*i.e.*, accelerating expense into the current fiscal period) and could result in the company recognizing more expense than necessary.

The Shallow End of the Pool. Accelerating vesting on options that are underwater but not deeply underwater has a different result. This is a substantive modification, but because the underwater status of the option still effectively prevents the executive from exercising, the option is now considered a market-based performance award.

Market-based performance awards are those where vesting is contingent on a performance goal related to the company's stock price. In this case, the goal would be for the stock price to increase to a point where the option is in-the-money. When determining the fair value of a market-based award, it is necessary to use an option pricing model that takes the market conditions into consideration. This will require a more sophisticated model than Black-Scholes, even some lattice models may not be sophisticated enough; we understand that a Monte Carlo simulation model must be used. [Monte Carlo simulation models are similar to lattice models in that they value options based on possible future stock price outcomes, but the model assumes random price paths, rather than the structured paths predicted in a lattice model.] In a case like this, where there is no set period of time in which the conditions must be achieved, the model is also used to calculate the service period over which expense must be recognized, which is the period of time in which the price targets are likely to be hit. (See our May-June 2006 issue at pg 8.)

Let's go back to our earlier example involving options to purchase 500,000 shares vesting over a one-year cliff period (and an expected forfeiture rate of 2%). Moreover, let's assume that these options are underwater at the time that vesting is accelerated (halfway through the vesting period). For the 490,000 options that were expected to vest anyway, the acceleration is still a probable-to-probable modification, thus there's no new calculation of expense for these options.

For the 10,000 options that were not expected to vest, we also still have an improbable-to-probable modification. Just as before, the company ceases to recognize the expense originally computed for these options and instead calculates a new fair value. But now, the new fair value must be computed using a Monte Carlo simulation model. This new fair value is likely to be less than the original fair value of the options, given that the options are underwater and the valuation model will further reduce the fair value based on the likelihood that the options will ever again be in-the-money.

Thus, it is possible that the acceleration of vesting could reduce the overall expense that the company must recognize for the options. But this will depend on the service period of the options and the forfeitures that occur during this period. For both portions of the option (originally

expected to vest and originally not expected to vest), the remaining expense will be recognized over the new service period derived from the Monte Carlo simulation model. This could be longer or shorter than the original vesting period. If an executive terminates prior to completion of the derived service period, the company ceases to recognize expense for the executive's options (and may even reverse some previously recognized expense) because their underwater status prevents the executive from exercising, forcing forfeiture of the options.

Evaluating the advantages of accelerating vesting in this scenario requires analysis of which strategy will result in greater forfeitures. Will more options be forfeited if the vesting conditions are left intact, enough to offset the reduction in expense achieved as a result of the acceleration? Or will the reduction in expense, combined with potential post-modification forfeitures result in less expense?

This analysis ultimately involves some risk, depending on (i) how accurately the company is able to predict estimated forfeitures and (ii) how accurately the Monte Carlo simulation is able to predict the derived service period. If the stock price recovers faster than predicted under the model, all remaining unamortized expense is recognized immediately in the period the options are first in-the-money. (The reverse is not true, however. If the options are not in-the-money by the end of the derived service period, the expense for them is still fully recognized within that period.)

Not Applicable to Acceleration of Vesting Upon Termination. None of these complexities relating to acceleration of vesting for underwater options applies when the acceleration is performed in connection with termination of employment. Because the employment relationship is broken, there's no longer any service period associated with the option and, thus, the treatment is the same as for an in-the-money acceleration of vesting upon termination.

Of course, we can't think of any reason why a company would accelerate vesting of an underwater option upon termination of employment unless the post-termination exercise period were also extended (or already a fairly extended period, *e.g.*, as is sometimes the case for retirees). If the option is underwater and the departing executive has only a short time to exercise, the acceleration provides no benefit to the executive but is going to cost the company (albeit, the cost may be minimal—although probably not immaterial, regardless of amount, if it involves an executive).

Making an additional modification to the option, such as extending the post-termination grace period, would further complicate the accounting considerations—perhaps the subject of a future article.

Thanks to Terry Adamson of Radford for assistance with this piece.

Respected CEO Takes a Stand on Compensation

Recently, at the Council of Institutional Investors Spring Meeting in Washington DC, Goldman Sachs CEO Lloyd Blankfein called for significant changes to the current compensation model. Blankfein's suggestions, while in some cases not going far enough to fix inherent problems, may at least serve to frame the debate over compensation reforms—and could be useful for all companies to consider as they re-examine their pay packages in the face of extraordinary shareholder and public anger. (It should be noted that, as a sign of the times, Blankfein was faced with protesters at the CII meeting when he delivered these remarks.)

Blankfein noted that compensation decisions must be made in the context a multi-year evaluation of risk to get a full picture of an individual's decisions, and that performance should not be judged in isolation. Among the specific guidelines that he suggested are:

• Compensation should include salary and deferred compensation, which is "appropriately discretionary" in Blankfein's view because it is based on performance over the year.

• The proportion of equity comprising an individual's compensation should increase significantly as total compensation for that individual increases.

• Senior employees should get most of their compensation in deferred equity, while more junior employees should get most of their compensation in cash.

• Individual performance should be evaluated over time to avoid excessive risk-taking and to

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allow for a clawback effect. (This is an area where the government's effort to implement clawbacks has been ineffective, because legislatively-mandated clawbacks would only come into play when financial statements or performance metrics later prove to be wrong.)

- Equity awards should be subject to future delivery and/or deferred exercise over at least a three-year period.
- Senior executive officers should retain the bulk of their equity until they retire, and equity should not be accelerated once someone leaves the firm.

We like Blankfein's suggestion that senior executive officers retain the bulk of their equity until they retire. To guard against an executive bailing just before bad news and to help ensure a long-term focus (and discourage excessive risk-taking), we prefer a policy that top-tier executives hold a substantial portion of their equity until two years after the later of both retirement and age 65. (For more on implementing hold-through-retirement policies, see our November-December 2008 issue.)

Also, Blankfein could have reminded companies to institute policies prohibiting executives from pledging, hedging or engaging in short sales with respect to their company shares or equity awards. (Goldman Sachs notes in its proxy statement that its executive officers are prohibited from hedging shares of the company's common stock or any equity-based awards.) [For more on pledging and hedging policies, see our Fall 2008 issue at pg 4 and the Winter 2009 issue of *Proxy Disclosure Updates* at pg 10.]

The most positive development here is that a respected CEO has recognized—and is speaking out—that the pay system has flaws which now require serious attention by CEOs and boards, and has suggested some constructive ways to fix the problems. It is important at this juncture for more CEOs and boards to take note and start implementing key fixes that will help restore public trust and preserve the system. (For three key fixes that CEOs and boards are urged to implement now, see our Fall 2008 issue and the *Special Supplement* to the September-October 2006 issue of *The Corporate Counsel*.)

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—JMB/BB

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