

RELOAD STOCK OPTIONS

T h e f i r s t t e n y e a r s

Frederic W. Cook & Co.

November 1998



Introduction^[1]

“Reload Stock Options” - Some people hear the term and imagine yet another opportunity for executives to enrich themselves. At least one major institutional investor considers the presence of this feature in a plan to be grounds for a “no” vote. However, this feature, also known by a number of other names, including accelerated ownership or restoration stock options, can be an important tool for encouraging stock ownership and a final piece of a comprehensive well-designed compensation program. As the reload option concept celebrates its tenth anniversary, many companies that have adopted this feature have found that properly designed reloads can be very effective at achieving their primary objective: to create greater executive stock ownership by encouraging early exercise of valuable stock options and retention of after-tax profit shares. During 1998, Frederic W. Cook & Co. conducted a research study among companies that have implemented reloads. This report summarizes the key findings of that study.

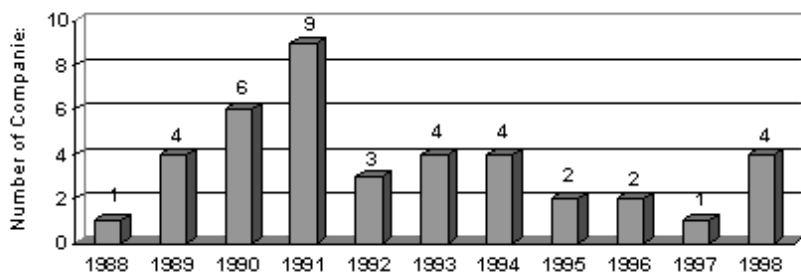
At the end of this report there is a list of definitions and terminology that may be helpful in understanding the concepts that are discussed. Throughout this report, reloads will often be referred to as “RSOs,” short for reload stock options.

Background

A “reload” is a stock option enhancement which allows an employee to exercise a valuable stock option before the end of its term, using already-owned mature shares, without giving up the benefit of future price appreciation on the full number of shares covered by the option. When the option is exercised using a stock-for-stock exchange, a new option is granted covering the same number of shares as those tendered to exercise the original option. The new option (which is referred to as the reload or restoration option) has an option price equal to the stock’s market value on the day it is granted and expires on the same date as the original option expired. Assuming the reload grant is made on the same day that the original option is exercised, the aggregate exercise price of the reload option will equal the aggregate exercise price of the original option grant.

Companies Implementing Reloads

As part of the research study conducted by our firm, questionnaires were mailed to 66 companies known to have implemented reloads. Of the 45 who responded, 40 continue to use RSOs. The majority of reload programs have been in place for more than five years, but companies are continuing to implement the feature. The following chart shows the number of companies in the survey that implemented RSOs each year.



How Reloads Work

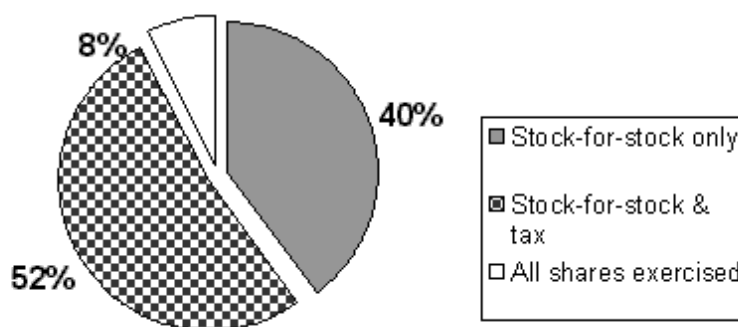
When an option is exercised using already-owned mature shares as the mode of payment, the optionee has less equity carried interest going forward than before the exercise. Assume an optionee owns 500 shares and uses them to exercise a 1,000 share option grant when the stock price has doubled. Before exercise, the individual had a carried interest in 1,500 shares, whereas after exercise the carried interest is in only 1,000 shares. This is a disincentive to early exercise of a valuable stock option if the optionee believes the prospects for continued appreciation are good and desires to maximize the potential benefit from that appreciation. The RSO overcomes this disincentive and encourages early exercise of a valuable option by permitting the optionee to capture the option profit in shares while retaining the full upside leverage. With the reload, after exercise the optionee in this example owns 1,000 shares, has a reload option on 500 shares and still has a carried interest in 1,500 shares.^[2] This early conversion of option profit has four effects for the employee:

- (1) it results in an increase in actual share ownership,
- (2) it provides the optionee with dividend and voting rights on the profit shares,
- (3) it dampens (but does not eliminate) the effect of a subsequent decline in stock price on option value, and
- (4) it allows for further appreciation on the option profit shares to be taxed as a capital gain rather than as ordinary income.

Types of RSOs

There are generally three types of reloads, depending on what shares associated with the underlying stock option exercise are reloaded.

- Stock-for stock reloads**—In a stock-for-stock reload, only the shares used to pay for the exercise cost of the option are reloaded. Sixteen of the 40 companies (40%) provide reloads only on the shares used to pay for the exercise price. This means that if 1,000 shares are exercised, 500 shares attested to for the exercise price, 200 shares withheld for taxes, and 300 net shares delivered to the executive, a reload option for 500 shares would be granted (carried interest goes from 1,500 shares to 1,300 shares).
- Tax reloads**—In a stock-for-tax reload, the shares withheld or used to pay for tax withholding are also reloaded. Twenty-one of the 40 companies (52%) provide reloads for stock-for-tax shares as well as the stock-for-stock shares. This means that if 1,000 shares are exercised, 500 shares attested to for the exercise price, 200 shares withheld for taxes, and 300 net shares delivered to the executive, a reload option for 700 shares would be granted (carried interest is 1500 shares before and after exercise).
- Total exercise reloads**—In these cases, all of the shares exercised are reloaded. This, in our view, violates a basic tenet of reload design which is to maintain equivalent carried-interest ownership after a stock-for-stock exercise. Three of the 40 companies (8%) provide reloads on all of the shares exercised. That means that if 1,000 shares are exercised, 500 shares attested to for the exercise price, 200 shares withheld for the exercise price and taxes, and 300 net shares delivered to the executive, a reload option for 1,000 shares would be granted as well (carried interest increases from 1,500 shares to 1,800 shares). This type of reload might also occur in the case of a cash exercise as well.



A “tax reload” is a somewhat controversial feature. Proponents argue that a tax reload is necessary to fully restore the employee’s carried interest and thus encourage early exercise of valuable stock options. Opponents argue that it is unnecessary and complex, as well as a drain on available pool shares.

Granting tax reloads brings additional focus to an issue that affects any stock-for-tax withholding feature, which is the issue of withholding in excess of the minimum required federal withholding rate (28% in 1998). Withholding above this rate may result in compensation expense for all the shares exchanged or withheld, so this issue needs to be thoroughly explored with the company’s auditor.

Alternatively, companies that want to keep the employee’s total equity

interest whole going forward without employing tax reloads can do so by offering pre-tax deferrals of option gains in shares of company stock. However, these deferred shares would not be available for future stock-for-stock exchanges.

Guidelines for Reload Program Design

There are many features and details that should be considered when developing a reload program. Following is a series of general guidelines for the effective and justifiable design of reload options. Associated with each guideline, we describe the results of our research related to that guideline.

- An RSO should only be granted when an employee exercises a vested stock option using already-owned “mature” shares.
 - ¾ In our research, this was true in 37 of 40 companies (92%). The other three provide reloads for all the shares exercised, regardless of whether the exercise was financed with cash or mature shares.
 - ¾ We are not aware of any company that allows the exercise and reload of an unvested stock option.
- The shareholder-approved option plan should be written in such a way that the shares tendered in a stock-for-stock exchange remain available for future grants, thereby funding the reload options, which are for the same number of shares. The reload option then does not reduce the pool of shares available for new option grants.
 - ¾ Thirty-two of 40 companies (80%) reported that they add back shares used in a stock-for-stock exercise when determining shares available for grant under the plan. Consequently, the effect of new options being granted in the form of reloads is offset by the shares surrendered in the stock-for-stock exercise. The remaining companies generally have language in the shareholder-approved plans to count only those additional shares actually issued due to an option exercise against the plan authorization. If owned shares are used to exercise the option and trigger the reload, through attestation or actual exchange, then the only additional shares issued would be the number by which the reload grant exceeds the shares used for the stock-for-stock exercise.
 - ¾ Some companies’ stock plans are also written so shares withheld for tax purposes also do not count against the pool of available shares.
- The exercise price of the reload option should be 100% of the fair market value of the stock on the date of grant. This should be the same market value used to determine the number of mature shares needed for the stock-for-stock exchange.
 - ¾ In all cases in our research, the exercise price of the reload option is equal to 100% of the fair market value of the stock on the day the reload is granted.

- The term of the reload option should be equal to the remaining term of the original option, so that, in effect, the reload is not a “new” option but rather a continuation of the original grant and no additional benefit is granted.
 - ³/₄ Virtually all companies in the study indicated that the reload option would expire on the date the original underlying stock option would have expired. That means that the term of the reload option is the remaining term of the original option. In two cases however, companies indicated that a new 10-year option is granted as the reload. Arguably, this is not a reload but rather a perpetual stock option and may have negative accounting ramifications.
- A reload should be granted only to an active employee or director. The reload feature is an ownership incentive, and the company and its shareholders have no reasonable interest in providing reloads to *former* employees or directors.
 - ³/₄ Most companies (34 of 40 or 85%) do not provide reloads to retired optionees that exercise their options during post-retirement exercise periods.
 - ³/₄ For the six companies that do provide reloads to retirees, no real pattern emerges as to any restrictions. One company requires compensation committee approval, another grants reloads for three years following retirement, and another for 90 days following retirement.
- Similarly, if a company offers option transferability, reloads should be granted only to the employee (without further transferability rights) and not to the transferee if the transferred option is exercised using a stock-for-stock exchange.
 - ³/₄ Option transferability has been implemented by 18 of the 40 companies, but only one provides reloads on transferred options. In this case, the reload is granted to the executive.
 - ³/₄ Note that an argument can be made that reloads should not be granted at all in this situation since the objective of increased ownership by the employee cannot be met.
- When first adopting the reload feature, it is reasonable to attach a reload right to previously granted and still outstanding non-statutory stock options (NSOs). Such an attachment should not be made to outstanding ISOs because it will result in their disqualification. Going forward, the reload feature should be attached to ISOs as well as NSOs.
 - ³/₄ At the time of implementation, 87% of the companies surveyed attached the reload feature to outstanding nonqualified options and all future options.
 - ³/₄ Even if the original option is an ISO, reloads should always be NSOs. The limits on the extent of ISOs first vesting in one year make it administratively impractical to grant reloads as ISOs.

- Reloads should be available to all key employees who normally receive stock options. There is little justification for limiting them to senior executives; however, for administrative reasons, it is reasonable for reloads not to be used with broad-based, all-employee stock option grants.
- ³/₄ Over half the companies extend the reload option right to all optionees (other than broad-based plans), while slightly over one-fifth limit reloads to less than 5% of their optionees:

<i>Percent of Optionees Eligible</i>	<i>Number of Companies</i>	<i>Percent of Companies</i>
100%	21	54%
99% - 80%	3	8%
50% - 15%	3	8%
14.9% - 5%	4	10%
4.9% - 1%	5	13%
< 1%	3	8%

- Multiple reloads (i.e., reload options on reload options) are appropriate as long as there is a minimum time period or appreciation requirement between exercises to limit administrative burden and increase the incentive power of the grant.
- ³/₄ Ten of 40 companies (25%) have price appreciation thresholds. Seven of these use percentage appreciation (25% in most cases). The remaining companies have dollar price appreciation thresholds, ranging from \$2.50 to \$5 per share. Most often, the option could be exercised if the price appreciation threshold had not been met, but no reload would be granted.
- ³/₄ Thirteen of 40 companies (33%) indicated a limit on the number of reloads that could be granted per original option. In almost all cases, this was one per grant. One company allowed two per grant and two allowed three per grant. The remainder (67%) permit unlimited reloads per grant, although often affected by a six month or other time limit between reloads.
- ³/₄ In one case, only options that have been held for at least five years are eligible for reloads, and then the executive must be in compliance with ownership guidelines or the reload cannot be exercised.
- Other conditions can be placed on the program that add incentive or assure that ownership objectives are met. These include limiting the sale of the profit shares from the exercise of the underlying option.
- ³/₄ Most companies (27 or 68%) do not place any restrictions on the sale of profit shares from an exercise triggering a reload, under the premise that ownership retention is necessary for future reload exercises.

- ³/₄ For the 13 that do place a restriction on these profit shares, there is no predominant pattern as shown in the table below:

Restriction on Sale	Number of Companies	Percent of All Companies
6 months	2	5%
1 year	4	10%
2 years	3	8%
5 years	1	3%
Other	3	8%

- If a company has optionees outside of the United States, reloads should be offered in other countries as well.
- ³/₄ Twenty-three of 40 companies (58%) indicated that reloads were provided to optionees outside the United States. The remaining 17 indicated that reloads were granted in the U.S. only, with no indication as to whether there were any non-U.S. optionees in those companies.
- ³/₄ Only four of the 23 indicated that tax reloads were granted outside of the U.S. This often requires some creative approaches because no tax withholding generally occurs on exercises of U.S. stock options outside of the U.S.
- Reloads need not be subject to new lengthy vesting schedules because the underlying option that was exercised had already fulfilled all of the original vesting conditions.
- ³/₄ The vast majority of reload grants vest in one year or less, but there are a wide variety of vesting schedules, as shown in the following table:

Vesting after Reload Grant	Number of Companies	Percent of Companies
Immediate	14	35%
6 months	13	33%
1 year	9	23%
2 year (50/50)	1	3%
3 year (1/3 per yr)	2	5%
3 year cliff	1	3%

— Percentages may not add due to rounding

- ³/₄ For the 14 companies that indicated immediate vesting, seven indicated that there was a six-month waiting period to exercise, and the remaining seven indicated that there was no waiting period.
- Since the positive aspects of reloads are equally appropriate for non-employee directors, companies with option plans for outside directors

may also wish to apply reloads for those options as well.

³/₄ Within the 23 companies in our study granting options to directors, nine (39%) include the reload feature with the director stock option. We believe that this number is likely to increase. Before 1996, reloads could not be used for non-employee directors because SEC regulations essentially required formula-driven grants. Since the revisions to Rule 16b-3, this requirement no longer exists and the door has been opened to offering the reload feature to outside directors.

Since the reload does not provide any additional shares to executives beyond those to which they were entitled had they waited until the end of the term to exercise their option, it is logical not to attribute any additional value to options with the reload feature for competitive comparison purposes.

³/₄ Only four of 40 companies (10%) indicated that they ascribe a higher value to stock options because of the reload feature for comparing option values across companies to determine grant-value competitiveness. Three of the companies apply a 10% premium, and the other company depends on an outside consulting firm for a valuation that includes a premium.

³/₄ This may be more controversial where tax reloads are offered.

Reload Effectiveness and Criticisms

On a scale of one to five, the companies surveyed were asked to rate the effectiveness of reload programs at increasing ownership, reducing overhang, and limiting downside option risk. These programs were judged to be most effective at increasing ownership and limiting downside risk, and least effective at reducing share overhang.

	High Impact	No impact			
Increasing company ownership among participants	38%	26%	3%	21%	12%
Reduce dilution overhang of outstanding unexercised options	7%	13%	20%	30%	30%
Limit downside option risk	18%	27%	21%	9%	24%

-- Percentages may not add to 100% due to rounding; not all companies responded on each issue

Other points mentioned regarding effectiveness include accelerating the company's tax deduction, positive communication opportunities, and assisting in recruiting.

Again on a scale of one to five, companies were asked to rate the significance of common criticisms of reload programs. These included complex proxy disclosure, FAS 123 footnote disclosure impact, administration and participant understanding, and negative shareholder votes. While not all companies responded to these questions, none of

these areas was seen to be a major problem, with proxy disclosure, FAS 123, and negative shareholder votes the least problematic, and participant understanding the most problematic.

	Not a Problem				Major Problem
Proxy disclosure of multiple option grants	53%	18%	21%	6%	3%
Impact on pro forma company earnings under FAS 123 disclosure	42%	36%	18%	0%	3%
Additional administration	15%	32%	44%	9%	0%
Lack of understanding by participants	9%	12%	38%	35%	6%
Negative votes on plan by shareholders	79%	18%	3%	0%	0%

-- Percentages may not add to 100% due to rounding; not all companies responded on each issue

The only other significant criticism mentioned was that reloads create an SEC Forms “nightmare.”

Future Trends

Reloads appear destined to continue their fate as one of the most misunderstood compensation tools, utilized by a slowly increasing minority of companies. The complexity of communication and administration is often a significant barrier to entry until someone who has experienced the opportunity that reloads provide comes on the scene. The final question in our research explored whether the companies that grant reloads would likely continue to grant reloads for the foreseeable future. Thirty-nine of 40 companies (98%) indicated that they would, a strong vote of confidence from those who know the benefits they offer.

Key forces influencing the implementation of reloads include:

- The decline of capital gains tax rates—this makes the early conversion of stock option gains to owned shares more advantageous, since future appreciation is taxed and lower rates with no loss in carried interest.
- Volatility of the stock market—since owning shares has less downside risk than having options, optionees are in a safer position if they have exercised a valuable option and locked in the option profit in the form of additional owned shares. [\[3\]](#)
- Focus on employee stock ownership—RSOs combined with stock ownership guidelines continue to be one of the most effective vehicles for significantly increasing stock ownership among employees.
- Increasing use of options for outside directors—as more and more companies adopt stock option programs for outside directors, it is likely that reload opportunities will be extended to them as well.
- Executive mobility—as executives who have experienced the

opportunities of reloads move to other companies or join boards of directors, they are likely to influence to spread of reloads as a tool to obtain the benefits it provides.

- Proliferation of option record-keeping software— option record-keeping systems significantly reduce the administrative issues associated with implementing RSO programs.

As with most compensation design issues, a company's culture, resources and competitive positioning will influence whether and how reloads are designed and used in any given situation. Maintaining a focus on and understanding of their ownership purpose should help guide companies in properly applying this important compensation tool.

Definitions and Terminology

Throughout this article, a number of specific terms are used in describing stock option programs and the RSO feature. For your reference, this terminology is defined below.

Attestation -- The process of tendering shares to exercise a stock option by simply certifying that they are owned, rather than actually physically surrendering the stock certificates (see stock-for-stock exercise below).

Carried Interest -- The total number of shares in which someone has a stake, or "interest;" having a carried interest in 1,500 shares means that for every \$1.00 the value of the stock increases, then the value of the person's pre-tax net worth increases by \$1,500.

Grant -- The award of a stock option.

Exercise -- The purchase of some or all of the shares from options that have been granted.

Exercise Price -- The price per share that must be paid to exercise an option. Typically, this price equals the fair market value of the stock on the date the option was granted. For RSOs, the exercise price is the fair market value of the stock on the date the underlying option was exercised (the same date the RSO was granted).

Exercise Period -- The period during which the option is exercisable. Typically, this period is ten years from the date of grant. For RSOs, the exercise period is the remaining term of the original option.

Fair Market Value -- The sale price of the stock on the date of the transaction; this is typically the average or the closing price, as reported on the New York Stock Exchange Composite Tape.

Mature Shares -- Shares that are generally either acquired (1) in the open market or (2) through a company plan, such as a stock option exercise or share grant, and held for a minimum specified period of time such as six months to avoid "pyramiding" (exercising an entire option with only one owned share, tantamount to a stock SAR) which triggers compensation

expense for the gain at exercise under Accounting Principles Board Opinion 25 (APB 25).

Option Gain -- The difference between the exercise price of the option and the fair market value of the stock on the date of exercise.

Profit Shares -- The additional shares owned after exercising an option, net of any shares used to satisfy the exercise price and/or income tax withholding.

Reload Stock Option (RSO) -- A new option granted when you use mature shares to exercise a stock option. RSOs may also be granted on shares used to pay the income taxes due upon the option exercise.

Stock-for-Stock Exercise -- The exercise of a stock option using mature shares of company stock to satisfy all or part of the exercise price. This is typically a "paper" transaction only; without actually surrendering stock certificates, but merely "attesting to" or certifying ownership of them. The company then issues only the *incremental* shares (that is, the number of shares normally received from the option exercise, less the shares deemed exchanged in the exercise). RSOs are received for the same number of shares used in the stock-for-stock exercise.

Stock-for-Tax Withholding -- The use of company stock as payment for all or part of the income taxes due upon the option exercise. Stock-for-tax withholding is accomplished by electing to have the company withhold shares normally received from the option exercise. If the stock-for-tax withholding is part of a stock-for-stock exercise, RSOs may be granted for the same number of shares withheld to pay taxes.

Vesting Period -- The waiting period during which a stock option may not be exercised. Typically, this vesting period is set forth in the stock option agreement. RSOs are typically fully exercisable either immediately or six months after they have been granted.

Company Profile

Frederic W. Cook & Co., Inc. provides management compensation consulting services to business clients. Formed in 1973, our firm has served over 1,000 corporations in a wide variety of industries from our offices in New York, Chicago and Los Angeles. Our primary focus is on performance-based compensation programs which help companies attract and retain key employees, motivate and reward them for improved performance, and align their interests with shareholders. Our range of consulting services encompasses the following areas:

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Questions about this study can be directed to George Paulin in Los Angeles or Mike Thompson in Chicago. Statistics were compiled with the assistance of James Kim in Los Angeles.

[1] This is an adaptation of an article by Leslie Winograd published in the Spring 1998 issue of the ACA Journal, which was an issue dedicated to stock options. The key changes relate to the incorporation of the results of a research effort our firm conducted earlier in 1998 with the assistance of 45 participating companies.

[2] Note that this example disregards the impact of taxes for the sake of simplicity.

[3] When the stock price falls beneath the exercise price of the option, the option is valueless unless the price rises again. If the stock is owned, the shares still have some value unless the price falls to 0.