

Agenda

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Boom Time Coming for Option Exchanges

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There should be a significant increase in option exchanges this fall, say compensation consultants.

Due to a **RiskMetrics Group** policy, boards are looking for a 52-week period where the highest stock price was still historically low. For most companies that period began Sept. 15, 2008 — the day Lehman Brothers went bankrupt.

RickMetrics guidelines for option exchanges encourage boards to include only those outstanding options whose exercise price is above the 52-week high.

Already option exchanges have been on the rise this year as the recession has pummeled stock prices. In the second quarter of 2009, 37 companies completed such plans, and another 71 are pending, according to **Equilar**. That compares to 26 plans that were completed during the first three months of the year, and only seven completed plans for the first quarter of 2008.

Board members are seeing that "if ever there was a case for a marketwide correction that would do something they were normally against, now would be the time," **Matt Ward**, a senior vice president at **Radford, An Aon Consulting Company**, said last month at the **World at Work** conference in Seattle.

Companies Take Different Approaches to Option Exchanges

As more boards are deciding whether to initiate a stock option repricing or exchange program to address underwater employee stock options, directors have to think about a number of factors, chief among them how to get

your investors on board.

More than half of all companies have equity plans that require shareholder approval to reprice or exchange options. Even if shareholder approval isn't required, many companies are putting the plans before their investors anyway. That's partly because RiskMetrics will recommend voting against the reelection of compensation committee members if the board approves a stock option exchange plan without first seeking shareholder permission. The proxy advisor also recommends that investors vote against equity plans that allow for repricing stock options without seeking shareholder approval.

In deciding what type of plan to pursue, boards are somewhat pigeonholed into the guidelines RiskMetrics has laid out. The company must have a reason other than market deterioration to reprice stock options, and, in addition to counting options priced above the 52-week high, the plan should exclude top executives or board members, provide a new vesting period for options and be a value-for-value exchange.

Brett Harsen, a vice president at Radford Consulting, says he is surprised by how rigid RiskMetrics has been in the type of stock option repricing plans it approves of. Then again, RiskMetrics' "whole business model is set on consistency," he says. The company's 52-week requirement is an area where the company has been particularly strict.

Intel's shareholders approved a stock option exchange program at its annual meeting last month, but **Cary Klafter**, the company's corporate secretary, says the company would probably implement it in the fall if they decide to at all. The company has nine months to initiate the plan or cancel it.

"You really only want to do this once in your life," Klafter says. (Intel never repriced or exchanged options during the dot-com bust in the early 2000s.) Assuming a stock price at current levels, the fall of 2009 will cover the largest portion of underwater options for Intel under the 52-week rule, he says.

The delay between stockholder approval and implementation of the plan also gives Intel time to educate employees and fine-tune the specifics of the plan. The chipmaker's plan would exchange underwater options for new ones that have the same terms as new options typically granted by the company, with a four-year linear vesting period and a seven-year life from grant.

Klafter says the board had been reviewing an option exchange "off and on" but when almost 100% of the outstanding options were underwater, "you really have to think like you've never thought before with your

equity plans.” The company hired RiskMetrics’ corporate consulting services and vetted the conceptual design for an exchange through the firm and reported to the board on the progress of the engagement, he says. Intel also had discussions directly with its large institutional investors, and many of their views about option exchanges were similar to those expressed by RiskMetrics, Klafter says.

The last option exchange frenzy was in the early 2000s because of the tech bubble. RiskMetrics wasn’t as influential in shaping the stock option repricing plans then because these programs were not always required to obtain shareholder approval, says Radford’s Harsen. Plus tech companies at the time had fewer institutional investors that relied on the advice of proxy advisors.

To win over investors, boards should emphasize the value to shareholders of these plans, experts say. Cancelling out underwater options reduces share dilution. It also incentivizes workers. However, there is little standard for how many employees need to be impacted. Nearly all of Intel’s employees had underwater options before the board decided to pursue an exchange, but only 45% of **Cardinal Health**’s employees are estimated to have underwater options. The health care company is putting an option exchange plan to a stockholder vote at its annual meeting June 23.
