Google to Offer Variation on Stock Options

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Published: December 13, 2006

In a move that will enable its employees to earn more money from stock options — and perhaps motivate them to settle for fewer of them in pay packages as a result — Google said yesterday that it would create a system allowing options to be sold as well as exercised.

Under the program, Google will grant employees a new type of option, called a transferable stock option. The company will work with Morgan Stanley to set up a market that will enable financial institutions and other investors to bid for those options.

Experts briefed on the plan were divided on whether it might provide a useful model for other companies. But the move appears likely to reinforce Google's reputation for financial innovation. When it went public in 2004, Google priced the initial offering through an auction, allowing any investor to get in on the offering, rather than granting assured allocations to preferred investors.

That led to an offering price of $85, which was below what some had expected. Those who bought have prospered, as the share price has risen to a high above $500. Yesterday it closed at $481.78, down $2.15, before the options plan was announced.

Google said the plan was aimed at showing employees the full value of their stock options. In addition to giving options to most new employees, Google also issues options annually to many employees who have been with the company for more than a year.

Stock options give their owner the right to buy stock for as long as 10 years at a price set when the options are granted. Google officials said they believed that employees typically underestimated their value.

"It is very difficult for employees to understand what their options are worth," said Dave Rolefson, Google's equity and executive compensation manager, in an interview. "If they can see what others would pay for them, then option valuation would become simple for employees."

The new options, which will have lives of 10 years, will have the same vesting schedule as existing

options, with some options vesting after 12 months and all vesting within four years. Once the options are vested, employees will be able to hold them, exercise them or sell them. They are likely to reap greater gains from selling than from exercising them.

For example, an employee who holds a vested option permitting him to buy shares at a strike price of $460, assuming the stock is trading at $482, can currently exercise the option and pocket $22. The new transferable stock option could be worth a lot more than that, because of the expectation that the stock could rise further.

Google said any options that are sold when their remaining life is greater than two years would immediately become two-year options. In those two years, the financial institution or investor buying them would not be able to sell the options in a secondary market, but would be able to use various financial instruments to hedge against fluctuations in Google's stock price.

The financial institution is likely to pay less than it would if the option life was not reduced, but much more than the employee would receive if he or she exercised the option and sold the stock.

In trading yesterday, an option to buy Google for $460 a share in January 2009, a little more than two years from now, sold for $123.50 in trading at the Philadelphia Stock Exchange, far more than the value that would have come from exercising it now. A financial institution that bought such an option now from an employee probably would pay a price below that level, but not too far below it.

Even options with strike prices higher than the value of the company's stock — so-called underwater options — would probably have some value in the market being created, and they could be sold by Google employees. Yesterday, at the Chicago Board Options Exchange, a January 2009 option with a strike price of $520 sold for $99.80. For years, technology companies opposed efforts of accounting rule makers to force them to record as an expense the cost of options granted to employees. Since the rule went into effect last year, some have tried to change the terms of the options, or the assumptions made in valuing them, to reduce the reported expense. But Google's change, because it will increase the expected life of the options, will raise the reported cost of each option.

In the long run, however, Google's reported profits could climb if it is able to offer fewer options to attract and retain employees.

"We want to continue to use stock options, but we don't want to be wasteful either," Mr. Rolefson said. "We won't need to use as many options to deliver the same value to employees."

Google is not the first company to offer employees the possibility of selling options, but it is the first to propose doing so regularly. In 2003, Microsoft arranged for J. P. Morgan to offer to purchase all options with exercise prices over $33 a share. Employees who took that offer have had no cause to regret it, because the share price has never risen to that level.