Comp Talks

Stock Option Exchange Programs

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Overview

- What are we solving?
- What is the range of solutions?
- What are the key considerations when designing a stock option exchange program?
- What about implementing a stock option exchange program?

Defining the Problem

What Is the Problem?

- Options are intended to retain and incentivize employees and align employees' interests with shareholders
- However, when the price of shares underlying stock options falls significantly below their exercise prices, these "underwater" or "out of the money" options may no longer serve the intended goals and worse, may contribute to declining morale
- Because outstanding underwater options count against equity plan share reserve limits, they may limit the number of new awards that can be granted to employees
- Companies are required to expense the value of outstanding stock options even when they are underwater
- There is often a disconnect between the objective accounting value and employees' subjective perceived value

Your House as Seen by . . . .

You…

Your Lender…

Your Buyer…

Your Appraiser…

Your Tax Assessor…

What Is the Magnitude of the Problem?

- How much of your total issued overhang is underwater?
- What is the underwater depth of options?
- Are the options only recently underwater (e.g., in the past 12 months)?
- What is the likelihood that stock price might rebound in the next 12 to 24 months based on specific micro- and macro-economic circumstances?
- Is waiting an option? Are you facing retention concerns? Will the annual bonus plan pay out nicely and provide some sort of compensation bridge? What’s happening in your industry?

Scoping Solutions

Potential Solutions

Alternative	Benefits	Drawbacks
Special or larger annual grant (*Issue a one-time grant or increase annual grant; could also use cash*)	• Simpler means of restoring incentives • Avoid cost and effort associated with an exchange • Allows targeting key employees	• May create a dangerous precedent • Also very unpopular with shareholders • Does not remedy unproductive overhang and the constant reminder of underwater options • Pool of available shares may be limited
Employee education (*Educate employees on the long-term value of options*)	• May improve perceived value and reduce cynicism • Avoid shareholder challenges	• Will not change the underlying economic realities of an underwater stock option
Do nothing (*Wait/hope/pray for recovery*)	• Avoid cost and effort associated with an exchange • Avoid shareholder challenges	• Retention of critical talent • Loss of motivation and alignment
Option exchange (*Swap out underwater options for new options with lower exercise price or other vehicle*)	• Directly and cleanly restore broken incentives via new equity vehicle • Share efficient • Rallying cry around a new baseline	• Sharp stock price recovery may make people worse off for having exchanged • Challenges obtaining shareholder approval

Potential Constraints

- Are there cash constraints?
- Are there share reserve constraints?
- Is shareholder approval needed for exchange program under express terms of stock plans/stock exchange rules?
- Are your shareholders influenced by proxy advisory firms?
- Is your issued overhang high?

Other Factors

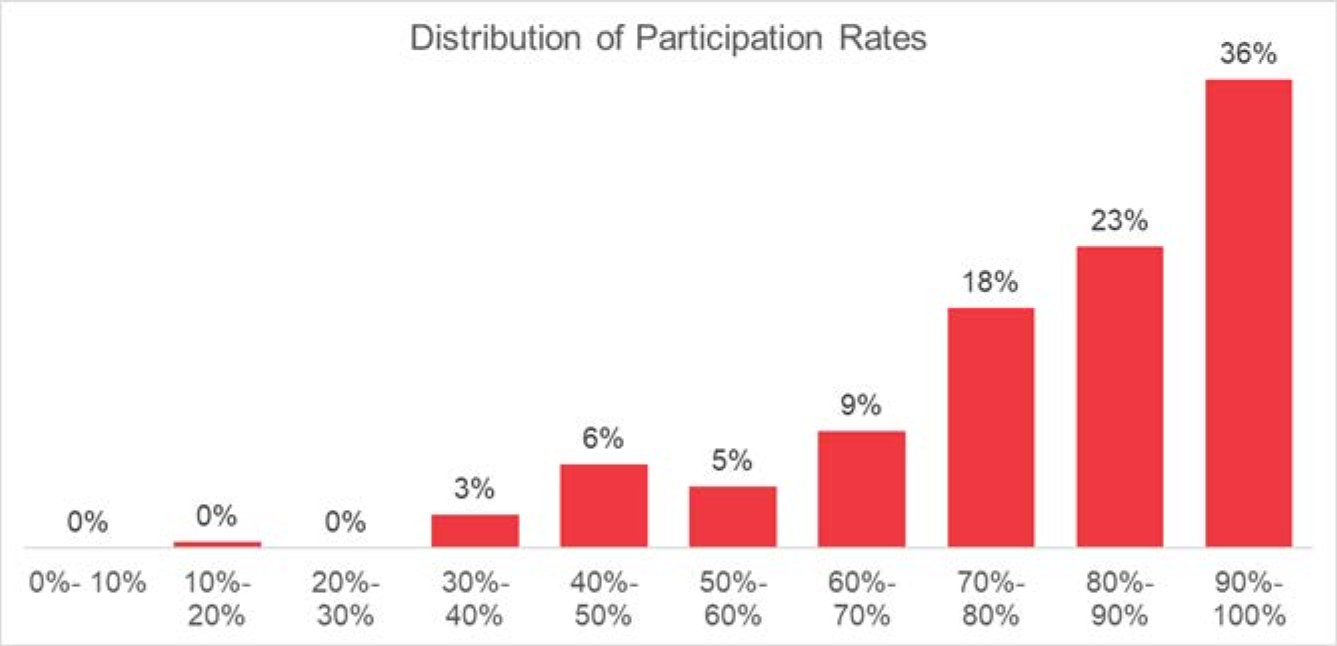
- What would each alternative communicate to employees about the future of your company, and what would be the resulting impact on morale?
- What is the cost of each alternative (design, implementation and communication), including monetary expense and impact on legal, finance and human resources teams?
- Is there a compelling business case that can be communicated to shareholders?

Option Exchange Programs

Challenges

- How to exchange options while
  - Keeping shareholders happy
  - Keeping ISS/Glass Lewis happy (if influential to your shareholders)
  - Keeping executives happy
  - Making employees happy again
  - Meeting all the regulatory requirements
  - Keeping administration manageable
- Structuring an exchange that is beneficial to all stakeholders:
  - The company
  - Employees
  - Shareholders

Participation Rates



Key Takeaways

- Excellent communication and robust terms substantially boost the odds of achieving high participation
- Still, many exchanges garner lower participation because employees are confused and do not understand the value proposition
- Solutions: program design and investment in messaging

Option Exchange Program Design

Design Question	Choices and Considerations	Common Practice
Option eligibility	▪ Usually in reference to a strike price (e.g., those with strike price > 52-week high) or grant date threshold (e.g., exclude recent options?)	▪ Exclude grants that are underwater by less than 20% or granted in last year
Participant eligibility	▪ Are executives and board members excluded? ▪ Optics potentially improved by excluding CEO or all NEOs	▪ Board usually excluded ▪ NEOs excluded 50% of time
Exchange vehicle	▪ Choice between options, RSUs/RSAs and cash	▪ Entirely depends on broader compensation strategy decision
Vesting schedule	▪ Decision to continue or restart vesting	▪ Vesting extended by fixed period
Contractual term	▪ If doing options-for-options, decision to maintain or extend term of new awards	▪ 2/3 reset contractual term
Exchange bands	▪ Number of bands (distinct ratios) to achieve dual cost and participant goals	▪ Three to five bands
Exchange ratio	▪ Incremental accounting cost tolerable? ▪ 1:1, value-for-value or other non 1:1	▪ Value-for-value common, but in practice, always some cost

Where to Start? Quantify Incremental Cost

Regardless of whether the goal is value-for-value, start by quantifying what exchange ratios yield $0 incremental cost

Then, create exchange ratio bands since it's confusing to have a different exchange ratio for every option

This facilitates an iterative stress-testing process: given these exchange ratio terms, will employees participate?

Iteration and Calibration

The raw data may have thousands (or more) grants, requiring a careful roll-up process to enable decision-making

Grant Price Range from	Grant Price Range to	User Defined Exchange Ratio	Value-for-Value Ratio	% Retained	Options Outstanding	New Options Issued	$3.11 Stock Price Scenario: Expected Incremental Cost 1	$3.11 Stock Price Scenario: Expected Under Compensation 1*	$2.50 Stock Price Scenario: Expected Incremental Cost 2	$2.50 Stock Price Scenario: Expected Under Compensation 2*
$0.00	$3.99	1.00	1.00	100%	35,122	35,122	$0	($22,928)	$0	($13,383)
$4.00	$4.99	1.00	1.32	100%	159,071	159,071	$61,844	$0	$62,490	$0
$5.00	$5.99	1.00	1.33	100%	4,285	4,285	$1,724	$0	$1,817	$0
$6.00	$6.99	1.00	1.40	100%	707,969	707,969	$285,623	$0	$296,525	$0
$7.00	$7.99	1.50	1.51	67%	238,071	158,703	$3,563	($828)	$20,214	$0
$8.00	$8.99	1.50	1.90	67%	63,045	42,022	$14,210	$0	$16,706	$0
$9.00	$9.99	1.50	2.00	67%	240,679	160,449	$26,058	$0	$38,923	$0
$10.00	$10.99	1.50	2.20	67%	57,726	38,481	$13,077	$0	$14,822	$0
$11.00	$11.99	2.00	2.50	50%	34,643	17,321	$0	($459)	$2,653	$0
$13.00	$13.99	2.00	3.19	50%	71,347	35,665	$21,440	$0	$22,679	$0
$14.00	$14.99	2.00	3.45	50%	217,732	108,855	$73,417	$0	$74,961	$0
$15.00	$15.99	3.00	3.63	33%	104,209	34,734	$9,787	$0	$15,042	$0
$16.00	$16.99	3.00	3.70	33%	154,626	51,539	$15,206	$0	$22,744	$0
$17.00	$17.99	3.00	3.90	33%	9,368	3,122	$981	$0	$1,404	$0
$18.00	$18.99	3.00	4.01	33%	260,159	86,681	$35,085	$0	$45,105	$0
$20.00	$20.99	3.00	4.19	33%	8,338	2,776	$684	($31)	$1,015	$0
$23.00	$23.99	3.00	4.25	33%	4,250	1,415	$281	$0	$472	$0
$25.00	$25.99	4.00	4.35	25%	33,530	8,382	$0	($1,388)	$765	$0
$27.00	$27.99	4.00	4.59	25%	11,775	2,943	$608	$0	$1,095	$0
$28.00	$28.99	4.00	4.65	25%	1,990	497	$134	$0	$206	$0
$29.00	$29.99	4.00	4.75	25%	3,210	802	$256	$0	$366	$0
$31.00	$31.99	4.00	4.80	25%	11,280	2,820	$1,526	$0	$1,751	$0
$32.00	$32.99	4.00	4.90	25%	7,272	1,816	$1,009	$0	$1,146	$0
$33.00	$33.99	4.50	5.00	22%	3,560	791	$134	$0	$287	$0
$37.00	$37.99	4.50	5.05	22%	1,292	287	$53	$0	$106	$0
$38.00	$38.99	4.50	5.70	22%	11,020	2,448	$1,523	$0	$1,664	$0
$41.00	$41.99	4.50	5.79	22%	131,834	29,273	$10,492	$0	$13,928	$0
$43.00	$43.99	4.50	6.00	22%	413	91	$67	$0	$68	$0
$46.00	$46.99	4.50	7.00	22%	1,210	268	$217	$0	$213	$0
$47.00	$47.99	4.50	9.09	22%	136,380	30,288	$24,553	$0	$24,302	$0
Grand Totals				**63%**	**2,725,406**	**1,728,916**	**$603,553**	**($25,634)**	**$683,468**	**($13,383)**

Ratios that yield a near value-for-value exchange

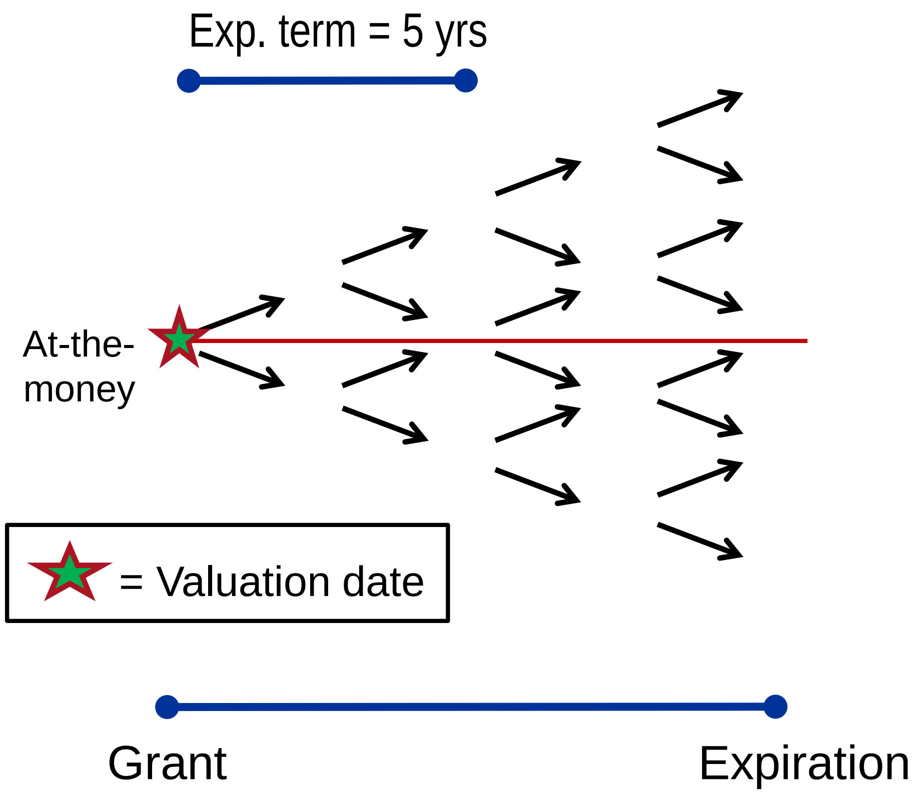
(100% V4V requires separate ratio by grant)

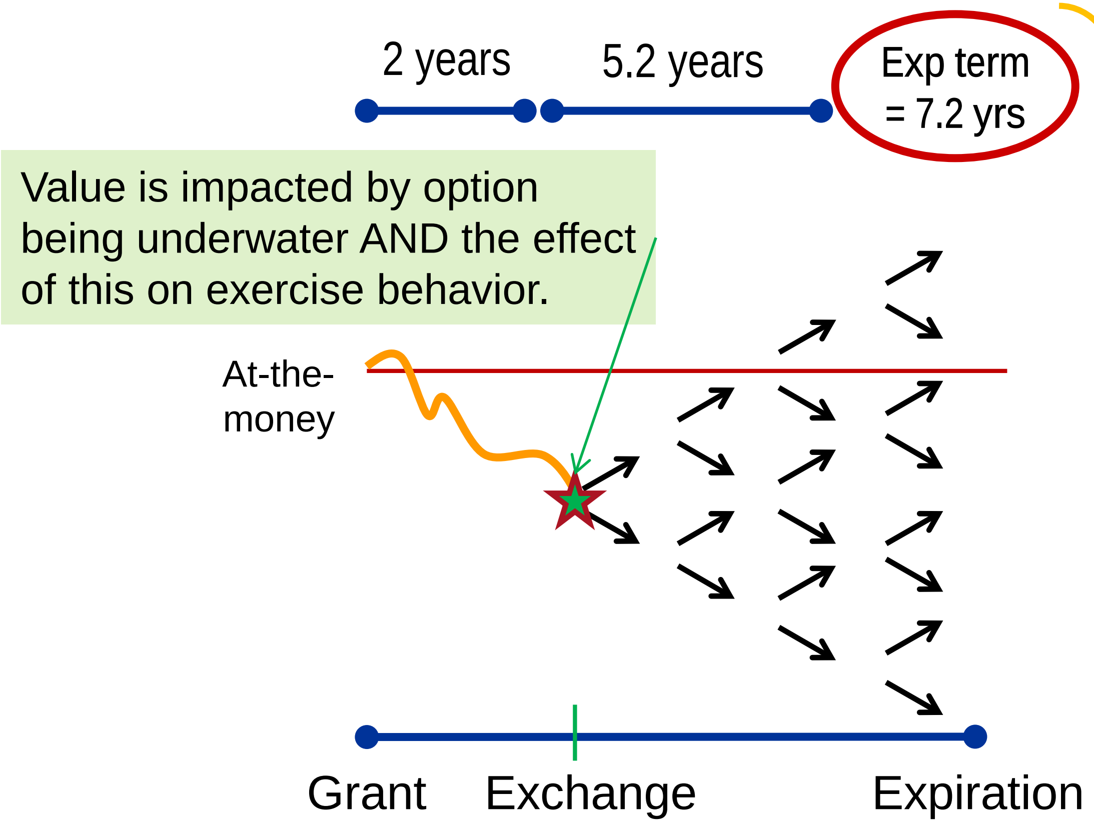
To reduce confusion and boost appeal, iterate toward custom ratios

But, of course, these cost money…

Option Valuation – Anything but Plain-Vanilla

Valuing partially- or fully-vested underwater options requires different approaches than those used to value new at-the-money grants



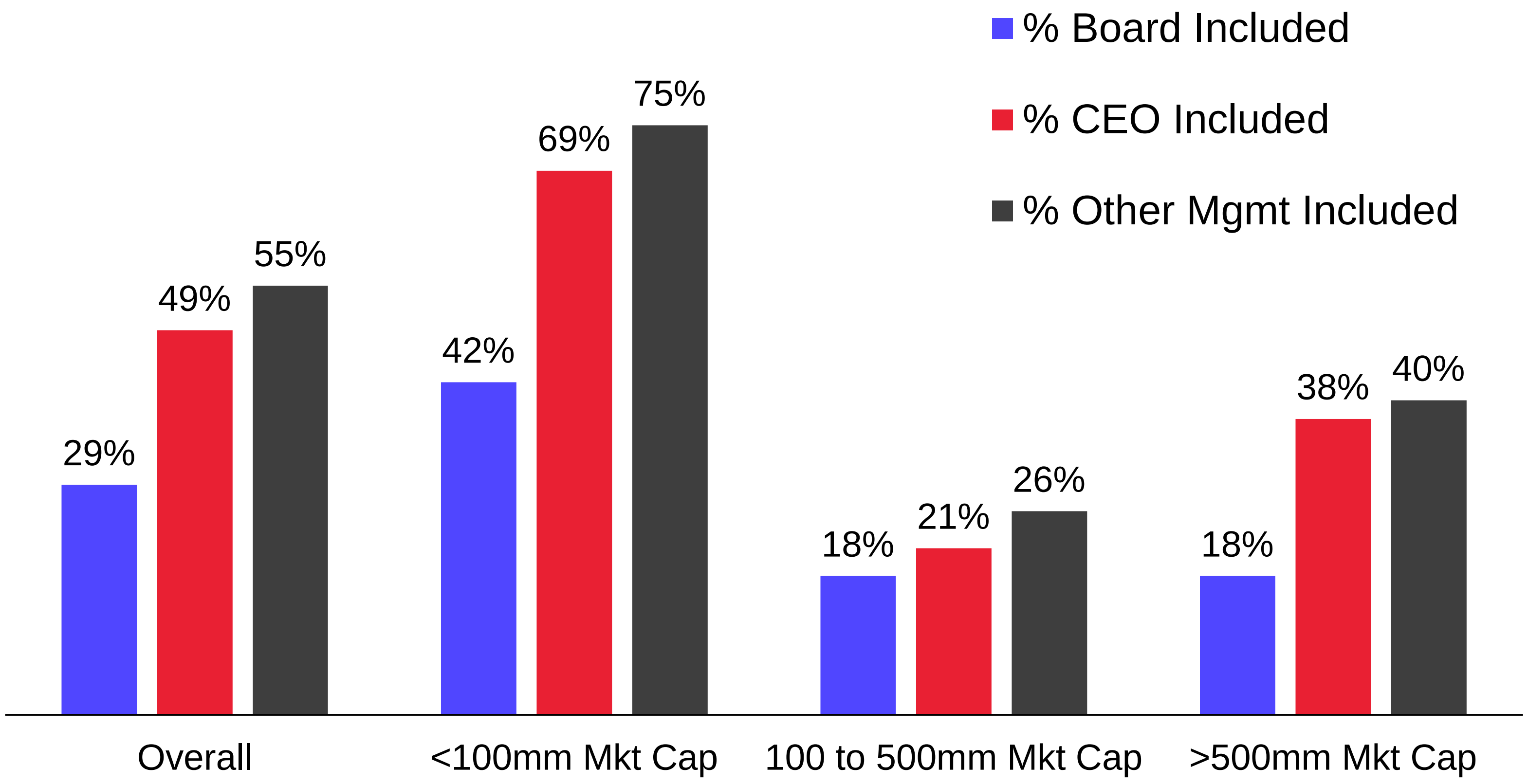


Requires use of a lattice model instead of Black-Scholes

Market Data

- From 2008 to the present, collected 234 option exchange cases
- Comprehensive focus across exchange vehicles, employee eligibility, cost neutrality vs. creation, participation rates and replacement award terms
- The content that follows is just a subset
- See appendix for examples of recent option exchange programs

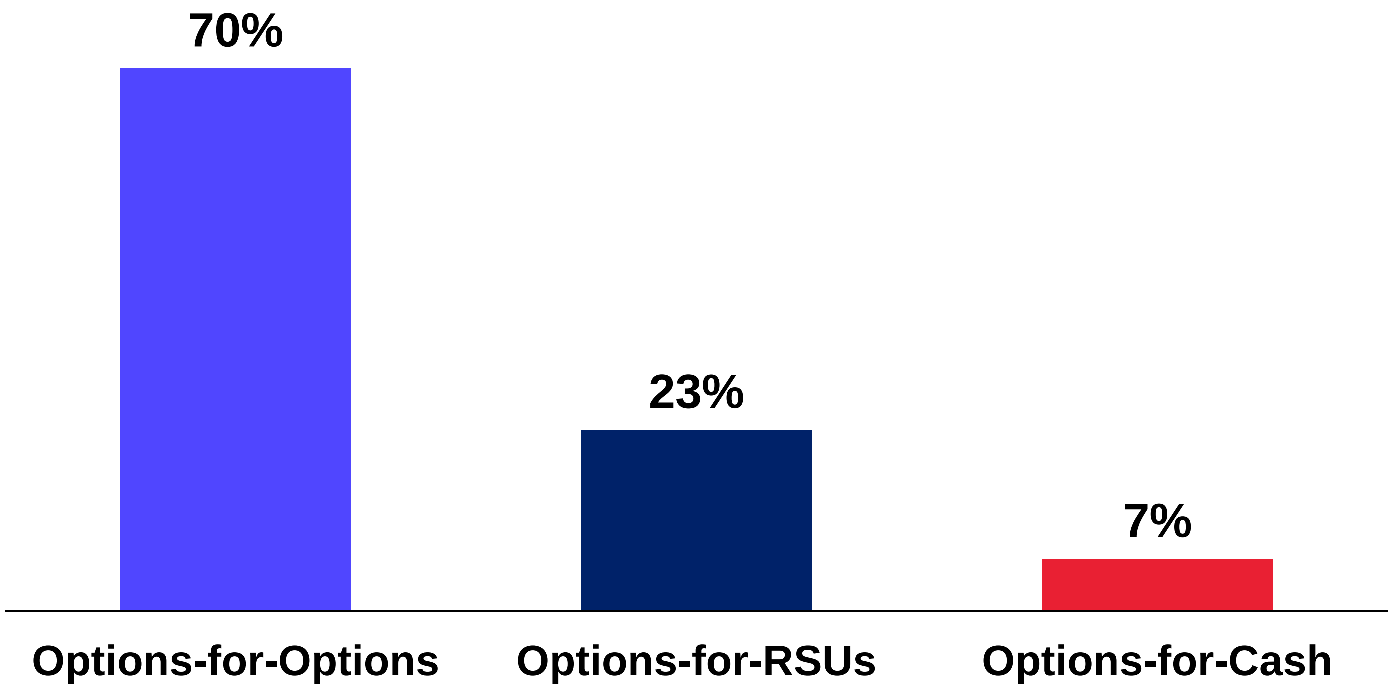
Employee Eligibility



Key Takeaways

- Common to exclude the board
- Smaller firms tend to include management and the CEO where retention risks outweigh governance risks
- Carefully balance program optics, shareholder messaging and overall retention risks by employee level

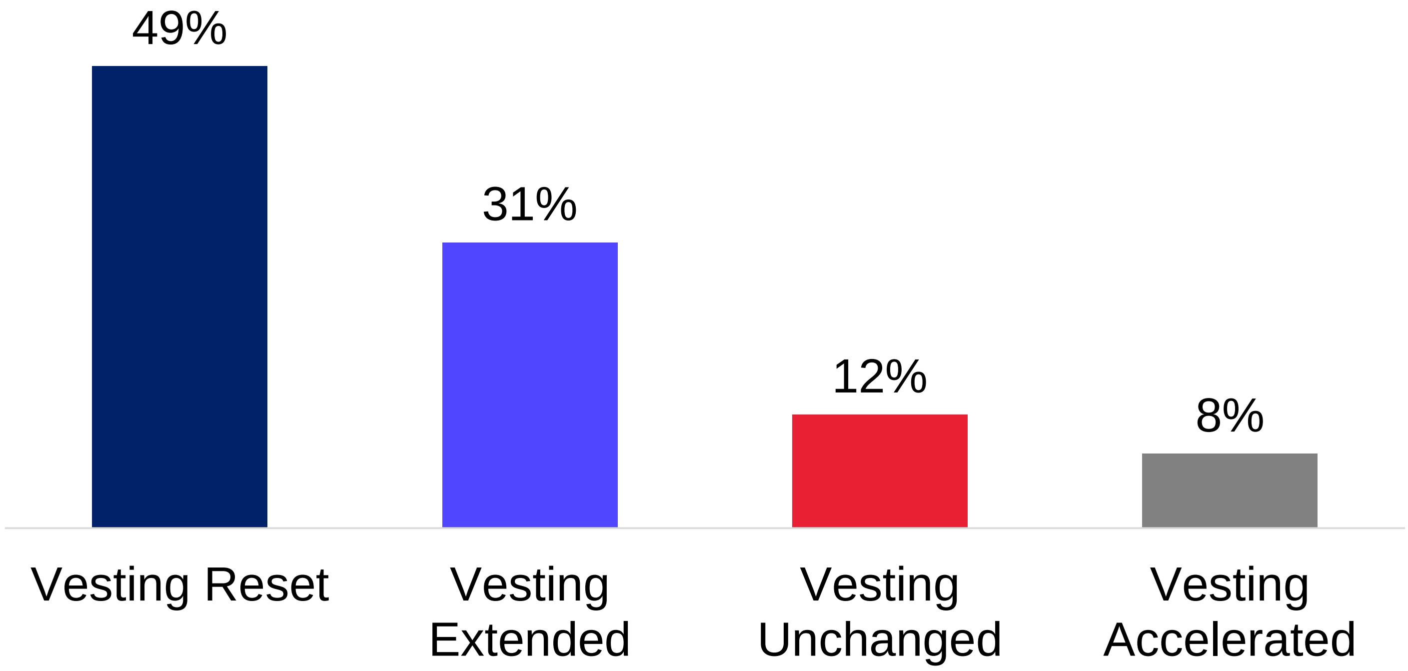
Exchange Vehicle



Key Takeaways

- Decision comes down to whether the exchange marks a broader shift away from options—a decision to stop granting them altogether
- Otherwise, common to replace options with new at-the-money options
- Some exchanges replaced underwater options with premium options
- Downside to RSUs is the low replacement quantity and easy possibility of employees being worse off if the stock price recovers

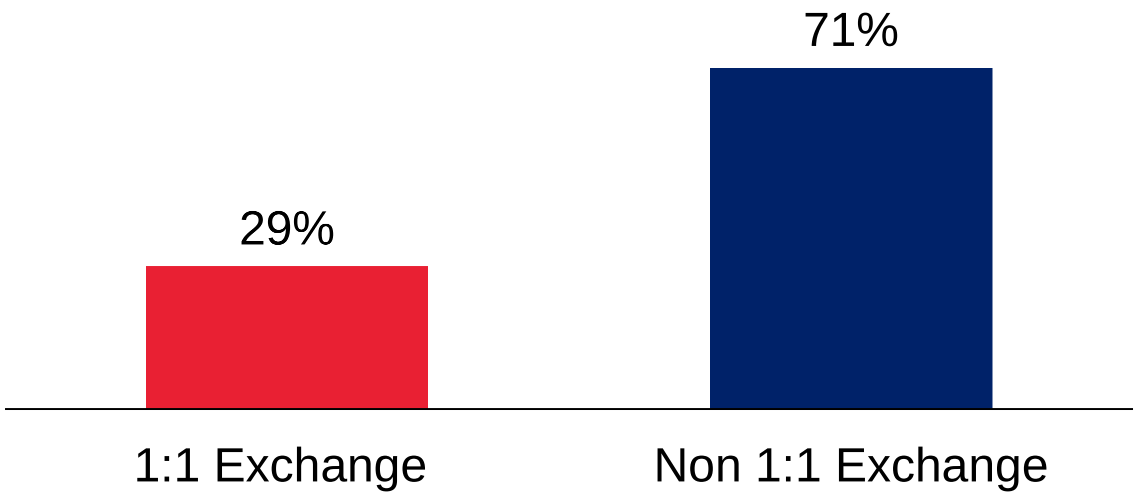
Vesting Treatment



Key Takeaways

- Most common to reset or extend vesting as an additional benefit to the company of offering the exchange program
- Generally not controversial and boosts overall value proposition of the program to shareholders by demonstrating there is not a built-in windfall

Exchange Ratio



Key Takeaways

- Non 1:1 much more common than 1:1 (including straight repricings)
- Considerable diversity in “non 1:1” category based on just how much incremental cost is tolerable
- Action item: iterative modeling to develop exchange ratios that balance additional accounting cost with overall appeal of the program’s terms

Develop a Short List of Designs

	Proposed	Alternative 1	Alternative 2
ISS Compliant?	Generally	No	No
Shareholder Approval	Required	Required	Required
Exchange Vehicle	Options-for-stock	Options-for-stock	Options-for-options
Employee eligibility	Exclude board & mgmt	Exclude board only	Exclude board only
Option eligibility	Strike prices > 52-week high	All options eligible	All options eligible
Value-for-Value	No (Keep cost < $1M)	Yes (Cost must = $0)	No (Keep cost < $1M)
Treatment of Surrendered Shares	Reinsert in shares	Reinsert in plan	Reinsert in plan
Vesting Schedule	Extend vesting	Extend vesting	Extend vesting
Contractual Term	N/A	N/A	Reset to 10 years


IMPLEMENT

Tip: Know Your Shareholders

- Who owns your stock?
  - Majority shareholders
  - Institutional shareholders
    - Who do they listen to?
    - Internal policies
    - Proxy advisory firms
      - ISS
      - Glass Lewis

Tip: How to Improve Shareholder Perception

- Seek shareholder approval even if plan permits action without approval
  - In absence of shareholder approval, ISS/GL will likely recommend voting against the next say-on-pay proposal and/or recommend withholding votes from compensation committee (or all board) members, even if program was expressly permitted under equity plan
- Adopt option exchange program INSTEAD of annual grant
- Retire shares instead of returning to plan?
  - Permanently impacts dilution
  - Prevents use for executive/board grants

Tip: Employee Communication Matters

Securities Issues

- A repricing or cash out program must be conducted as a tender offer pursuant to Section 13e-4 of Exchange Act
  - Exceptions:
    - no investment decision - e.g., unilateral reduction in the exercise price of nonstatutory stock options with no other change in terms
    - individually negotiated arrangements to a small group of people (10 or fewer people?)
- Tender offer rules require:
  - Public filing of Schedule TO plus all written communications (***including pre-commencement communications***)
  - Keep open for 20 business days
  - May have limited ability to launch a TO if material corporate transactions or share buy-backs are occurring / planned

SEC Disclosure/Reporting Requirements

- Cancellation of the underwater option and receipt of any replacement securities must be reported by Section 16 insiders on a ***Form 4 report*** filed within two business days after the effective date of such cancellation (the date the company accepts the tendered options)
- The cancellation of the option and the receipt of the replacement security should qualify for one of the exemptions under SEC Rule 16(b)-3, so that there are ***no deemed purchases or sales of securities for Section 16(b) short-swing trading purposes***

Tip: Reduce the Administrative Burden

Proxy Disclosure Reporting

- **CD&A/executive compensation section** of proxy statement must address the reasons for the exchange program and its conformity to the company's stated compensation philosophy, if the named executive officers participate
- **Summary Compensation Table**
  - Incremental fair value of replacement award must be included to the extent amortized over the fiscal years covered by the table
- **Grants of Plan-Based Awards Table**
  - Replacement grant must be included in the table, and the incremental value of the replacement grant disclosed in the "Grant Date Fair Value" column
- **Outstanding Equity Awards Table**
  - Replacement grant must be disclosed in the table/footnotes
- Description of exchange program must form part of the narrative discussion accompanying the tables

Standard Process to Address Key Requirements

1 Assess and Validate Need

- Key securities and proxy requirements
- Quantify risks and business case
- Meet with key vendors (legal, economic modeling, accounting) to learn key issues
- Understand high-level design choices and levers to pull
- Socialize concept with comp committee and exec management
- Develop timeline

Goals

1. Green light to proceed
2. Process familiarity

1 – 3 weeks

2 Design Strategy and Modeling

- Develop high-level design strategy and short-list of alternatives
- Form perspective on cost neutrality ("value-for-value")
- Iterative modeling of short-list of scenarios
- Develop exchange ratios/bands approach
- Quantify accounting
- Form and present design proposal to comp committee

Goals

1. Proposed design and alignment to strategy

3 – 4 weeks

3 Shareholder Approval

- Shareholder approval usually required
- Assess need for formal proxy solicitation to drive further votes
- Consider special proxy or component of annual proxy
- Develop narrative and analytics to support shareholder proposal

Goals

1. Strong shareholder proposal

2 – 3 weeks

4 Tender Offer Prep and Execution

- Define and refresh final exchange ratios to be current as of TO date
- Arrive at plan to handle post-TO accounting
- Develop materials to communicate the TO
- Make technology decision for TO administration
- Launch TO and manage during open window

Goals

1. Current exchange ratios
2. Drive employee clarity through solid materials
3. Efficient administration

4 weeks

5 Post-TO Accounting and Administration

- Tabulate final participation and overall results
- Update records in administration system
- Update comp committee on TO outcome
- Refresh valuation for modification accounting
- Test for and calculate incremental cost

Goals

1. Incremental cost tabulation
2. Administration

2 weeks

6 Ongoing Accounting

- Finalize accounting policy memos
- Make decision on accounting process:
  - Reengineer existing
  - Outsource/other
- Develop additional controls
- Run tests and validate accuracy
- Coordinate 10-K and proxy disclosure

Goals

1. Smooth ongoing reporting process

Ongoing

Appendix

Recent Option Exchanges

Company	Date of Schedule TO Filing	Shareholder Approval Sought?
Medpace Holdings	August 5, 2019	No
Five Prime Therapeutics, Inc.	July 1, 2019	Yes
SilverBow Resources, Inc.	N/A (special exchange program for NEOs only)	Yes
Vince Holding Corp.	April 26, 2018	Yes
Impinj, Inc.	April 18, 2018	No
CareDx, Inc.	October 12, 2017	No
Fluidigm Corp.	August 23, 2017	Yes
Fitbit, Inc.	June 21, 2017	Yes
RTW Retailwinds, Inc. (formerly New York & Co., Inc.)	June 1, 2017	Yes
R1 RCM, Inc. (formerly Accretive Health, Inc.)	May 12, 2017	Yes
Enphase Energy, Inc.	April 3, 2017	No
RealNetworks, Inc.	November 3, 2016	Yes
Ribbon Communications, Inc. (formerly Sonus, Inc.)	N/A (exchange program was not approved)	Yes
Castlight Health, Inc.	January 12, 2016	No

Options-for-Options

Advantages	Disadvantages
• Ease of communication • Reduce burn rate, overhang & dilution • Some plans allow exchange without shareholder approval • Retain the leverage of an option • Correct subjective-objective value differential	• Negative employee reaction: employee skepticism toward options if share price decline has been protracted • New options may also fall underwater • Many systems cannot support; ongoing accrual must be done manually

Option-for-RSAs/RSUs

Advantages	Disadvantages

• Cannot fall underwater
    • Less volatile form of compensation
• Rebalances employee portfolio
• Larger reduction in overhang, burn rate & dilution
    • Fungible share counting?
• Further reduce dilution if shares withheld for taxes
• Correct the subjective-objective value differential
	• RSAs/RSUs
	    • No cash inflow for option price
	    • Fixed taxable event
	• Employee upside reduced by fewer shares issued – “less leverage”
	• Some plans may not allow without shareholder approval
	• Many systems cannot support; ongoing accrual must be done manually

Options-for-Cash

Advantages	Disadvantages
• Biggest reduction to overhang, burn rate & dilution • No more underwater options • Immediate value to participants (when no vesting) • Correct subjective-objective value differential • Accelerates expense into current period	• Company cash outlay • No cash inflow for price • No leverage (stock growth) • Differences in cost of equity vs. cost of cash (perceived and real) • No alignment of employee/shareholder interests • No retention & attraction features (w/o vesting) • Fixed taxable event • Many systems cannot support • Potential “all holders / best price” issues • Accelerates expense into current period

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