# Net Exercise Considerations

Net exercise is getting a lot of attention these days. With the implementation of FAS 123(R) as the US accounting standard for share-based payments, the negative accounting treatment of net exercise was eliminated. In addition, many companies are looking for ways to reduce the dilutive impact of equity grants. So some companies are now considering implementing "net exercises" as a choice (or in some cases a mandate) for their participants. We have gotten a number of questions on implementing this practice over the last few months, and are speaking about it twice in December alone. So let's dive in and discuss the details.

**What is a "net exercise"?**

A net exercise is the practice of "tendering back to the company" some of the exercised shares to cover the exercise price of the option. In some cases, shares will be tendered to cover taxes as well. Many people find this more understandable when we call it "withholding shares" since the participant never actually holds the shares, the company just issues the "net shares" to the participant, hence the term "net exercise".

Let's talk through an example: Let's say you have a non-qualified option with 100 shares. The price is $10 per share and the current market value is $25. To exercise the 100 shares, the participant must pay the $1,000 of the option price (100 shares * $10 price per share). In a net exercise, you would simply divide the amount due by the market value and withhold that many shares: $1,000 / $25 = 40 shares to withhold. 60 shares are issued to the participant. Now let's add in taxes. If you assume a 40% tax rate, the participant would owe $600 for taxes ($1,500 gain * 40% tax rate), divide that by the $25 market value, and you withhold another 24 shares for taxes. The participant receives 36 shares.
Please note that the end result of the transaction is shares, not cash. Some companies are exploring net exercise as an alternative to same-day sales, where the end result of the transaction is cash to the participant. In its current form, net exercise does not produce the same results as a same-day sale.

**Some Advantages of Net Exercise:**

- **Same result for the participant, with no cash outlay** In a cash exercise, where the participant must fund the exercise out-of-pocket, the participant will end up with more shares, but the initial economic result is the same. They hold shares worth $2,500, but they had to pay $1,600 to receive those shares. The end result is a $900 "gain". When you issue only 36 shares after withholding shares for price and tax, again the participant ends up with a value of $900 (36 shares * $25 market value), but the participant didn't submit any cash to initiate the exercise.

- **Reduces plan dilution** Since only 36 shares are issued into the market, not 100, the impact to your earnings per share is much, much less. In many cases those 64 withheld shares are retired and thereby lose their ability to contribute to dilution in the future. In some cases, those shares are added back to the plan pool and can be granted as options or other vehicles in the future. That practice, however, comes with its own considerations, which we'll discuss further later.

- **Encourage share ownership without out-of-pocket investment** Since the participant is not required to invest their own funds in the exercise, some companies are using this as an easy way to encourage actual share ownership without the risk of a cash exercise.

- **Not reported as a sale on Form 4 and does not require a Form 144** Yes, the exercise is form 4 reportable, but not as a sale; the shares are "disposed" back to the company instead. In addition, since no sale occurs as part of the exercise, no form 144 is required either.

**Some Disadvantages of Net Exercise:**

- **Limited automation** Software and platform support are still evolving for net exercise because it is just beginning to be requested by issuing firms. Many firms that are currently offering net exercises have manual processes around it. Some vendors have recently updated their platforms to support net exercise and there are workarounds for some other platforms, but you should be aware that most processes are still more manual than for other types of exercises.

- **Same considerations as RS/RSU with share withholding** All the same issues encountered in withholding shares for taxes on restricted stock or units also apply to net exercises. Cash inflow is reduced since you are no longer receiving the exercise price from the participant. If you choose to withhold shares to cover taxes, cash outflow will increase, since the funds due to the IRS no longer come from the exercise. And the funds are due nearly immediately if/when your company's cumulative liability exceeds $100,000 (the exception that allows more time to remit funds applies only to same-day sale exercises of non-qualified options). And determining tax rates for international participants is a challenge since there are generally no "one-size-fits-all" tax rates in non-US tax jurisdictions.

- **IFRS 2 & Liability Accounting for Shares Withheld for Taxes** As you've probably heard, the adoption of IFRS by US companies may be required by 2014. IFRS 2, the international accounting standard for share-based payment, requires liability accounting for grants where the number of shares to be delivered may vary (as they would if shares are withheld to cover taxes). So, if an award allows a participant to pay taxes via share withholding, liability accounting is likely to be required for that grant. However, please note that this is not an issue if you are withholding shares to cover the option price (since that is a fixed amount), only shares withheld to cover taxes.

**Other Things to Consider**

- **Rounding** Just as with share withholding for taxes on restricted stock, to round up, or round down, that is the question. And the issues are the same too. If you round up, you are "over-withholding" taxes, and some audit firms have recently begun to assert that rounding up may trigger liability accounting. If you round down, you are under-withholding and need to collect the small remainder in cash in some manner. Some companies collect via check (generally because their plans will not allow other methods), but most seem to collect the remainder through payroll. (Note that collecting the amount through payroll for your insiders might be problematic due to the prohibition on "loans" to insiders.) In addition, we believe that if you are withholding shares for both price and taxes, it is a best practice to compute the number of shares due for price and tax separately and apply the rounding separately so that the number of shares withheld for tax vs. price can be determined for accounting purposes.

- **Which Market Value to Use** Since you must have a determinable market value to know how many shares to withhold, which market value will your company use? Some companies use the market value from the prior trading day's close since that allows the number of shares to be issued to be determined immediately. Some of our clients have rejected that because of the possibility of the participants' "playing the market" since the prior day's closing value is known. However, if you use the closing value from the current trading day, the results of the transaction cannot be known until after the market closes. Some clients have insisted that a "spot price" be used – the price at which the shares are currently trading at the moment the exercise is initiated. However, since there is no market transaction from which to determine price, at least one industry expert has asserted that this practice would likely be risk-prone due to the possibilities of manipulation and fraud.

- **Returning Withheld Shares to the Plan** As alluded to above, some plans do allow companies to return shares withheld to the plan so that they can be "reused" for other grants. However, under more recent guidelines, some proxy advisory firms, such as Riskmetrics, consider this practice "liberal share counting" and will count shares in plans with these provisions as "full-value shares" (like restricted stock) when performing their calculations on Shareholder Value Transfer (SVT). This does not preclude the use of the provision, but it may mean that the proxy firm will approve fewer shares for your plan. If your primary goal is the reduction of dilution, a best practice is to retire these shares instead of returning them to the plan. That may not extend the life of your plan, but since they cannot be reissued, they will never become dilutive.

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