Paper 10

The mechanism of employee stock option plans in the United States (US) ©

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A. Introduction

Employee stock option plans, employee stock purchase plans, eligible director's stock plans and similar variants which offer employees, consultants and directors an opportunity to participate in the success of the company in which they impart their knowledge and skills have been in vogue in the United States (**US**) since the early seventies. Such schemes have proved extremely useful and necessary for recruiting and retaining the best talent.

Although numerous kinds of employee stock option plans exist, the basic premise of most is that employees are given the option of buying a specified number of shares at a fixed price. The option can be exercised over a period of time, which allows employees to wait and see if the value of the stock appreciates before buying it. During periods of rising stock prices, income from stock options can be sizable. For high salaried executives, income from stock options can easily double their income from bonus plans and exceed their base salaries. In 1984, for example, one CEO received $ 17.9 million in total compensation, of which $ 800,000 was towards salary and bonus and the rest was from exercising stock options, some dating back as far as 1971[1].

Studies conducted in the United States consistently prove that employee ownership combined with a participative management style yields the best results. In technology and software industries, where skills of the employees are the actual asset of the companies, employee stock option plans predominate. Some companies restrict stock options to their top executives, others ensure that these benefits are available down the line.

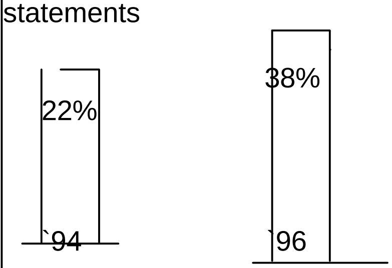
A participative management style together with employee ownership yields the best results. A 1987 General Accounting Office (**GAO**) report, about one-third of all companies providing employee stock option plans had some degree of employee participation.

[1] Source: The Management of Human Resources, by Cherrington

B. Statistics

[2] EXECUTIVES EXPECTED TO OWN STOCK

% of companies US companies with shareownership guidelines in proxy statements



Source: Pearl Meyer & Partners, survey of 95 companies with revenue of $2bn plus

Number of Plans and Employees[3]
Survey conducted by the National Centre for Employee Ownership

Type of plans	Number of plans 1996	Number of employees 1996	Value of plans (assets as on..)
Employee stock ownership plans & stock bonus plans	10,670	8,700,000	$ 213bn (1993)
401(k) & profit sharing plans	2,000	2,000,000	$ 250bn (1995)
Broad stock option plans	2000-4000	5,000,000	$ 200bn (1996)

Statistics prove the popularity of employee stock option plans and its variants. However, not all are in favor of such plans. A few views abound that such plans do not boost employee morale and productivity, which are the twin objectives on which such plans are based.

C. The downside

- Options do not pay for expected performance: A company's stock price on the market reflects the investor's collective expectations about the company's future performance. The stock price movements are not an exact reflection of the efforts put in by the employees and the productive and financial performance of the company.

[2] Source: Journal of Accountancy, December 1996
[3] Source: The Stock Options Book (1997), by David Johanson

- Executives have a limited influence on stock prices: Empirical research shows that over one-half of the variance in a company's stock price is due to industry factors, stock market trends and macro-economic conditions. These conditions cannot be influenced by executive performance.

- Immediate liquidity will not yield loyalty objective: If employees can sell their stock options, without any lock in period or after a few months span, the objective of retaining the best talent is lost.

- Options are not cost effective: Executives discount the value of the options they receive because usually the executive's portfolio is not diversified and the option is a more risky investment for the executive as compared to the typical stockholder. Another reason for the discounted value of an option is due to the risk of involuntary termination that could shorten the option's term or make it unexercisable[4].

Although stock options were originally intended to be incentives for performing well, they are now considered as a membership reward rather than a performance reward. Employees participate in stock-option plans because they are members of the organization rather than because they have performed well. The market value of the stock can be materially influenced by only a few top executives and even these executives believe that the relationship between their performance and stock price is weak. Therefore, the incentive value of stock options is nil[5].

Inspite of divergent views on the direct nexus between employee stock option plans and increased motivation and thereby increased productivity, most public offerings in the US mention details of various variants of employee stock option plans. ***Nishith Desai Associates*** conducted a study of various offer documents of US based companies. Enumerated below are examples of various employee stock option plans culled from such offer documents together with details of rules and regulations which such companies have to comply with.

Note: *The study conducted showed that a major portion of the rules and regulations covering stock options and their variants are laid down by the Internal Revenue Code (**IRC**). These regulations cover the eligibility criteria for stock options, insistence on a written plan outlying the stock reserved under employee stock option plans, stock holders approval, administration of this scheme, pricing et all. On the other hand, in India, the Central Board of Direct Taxes (**CBDT**) [6]in its circular has concentrated only on the tax*

[4] Source: "The truth about executive stock options:flaws,fixes and facts", Compensation and Benefits Management (1991), by Robert C Greenburg
[5] Source: The Management of Human Resources, by Cherrington
[6] CBDT's circular no 710, July 24, 1997: Shares issued to employees at less than market value amount to a perquisite. Where the shares held by the government have been transferred to the employee, there will be no perquisite because the employer-employee relationship does not exist between the government and the employee (transferor and the transferee); where the company offers shares to the employees at the same price as have been offered to other shareholders or the general public there will be no perquisite; where the shares have been offered only to the employees, the value of the perquisite

*implications. The Securities Exchange Commission (**SEC**) has recently relaxed guidelines regarding reporting of trading of stock option stock and has inserted Rule 16b-3. These rules of the SEC would be useful in determining a corporate insider in the Indian context in relation to trading of stock options. Mention is also made in this article of the new accounting standard introduced by the Financial Accounting Standards Board (FASB) relating to Accounting for Stock Based Compensation. No comparative accounting standard or guidance note has so far been issued by the Institute of Chartered Accountants of India (ICAI). Lastly, the listing requirements of the New York stock exchange are enumerated in this article. Appropriate illustrations have been provided whenever necessary. It is hoped that our research into these aspects covering all the possible rules and regulations will help SEBI introduce exhaustive guidelines on stock options in India.*

D. Types of Stock Option Plans and IRC Regulations

(i) Employee Stock Options
- Incentive Stock Options
- Non qualified Stock Options

(ii) Employee Stock Purchase Plans
(iii) Eligible Directors Stock Plans
(iv) 401(k) Plans
(v) Others such as:
- Restricted Property Plans
- Stock Appreciation Rights
- Phantom Plans

Employee Stock Options (ESOs):

An ESO basically bestows upon the employee the right to purchase a specific number of shares of the company in which he is employed at an option price within a specified period of time. The option price, is the amount which the employee would have to pay when he exercises the option. In most cases, it is the fair market value of the stock on the date the option was granted.

ESOs are of two types:
(I) Incentive stock options (**ISOs**) and
(ii) Non qualified stock options (**NQSOs**)

If an ESO does not meet the requirements laid down by the Internal Revenue Code (**IRC**) , it is deemed to be a Non-qualified stock option. The basic difference between the two lies in the tax burden which is ultimately borne by the employees.

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will be the difference between the market price of the shares on the date of acceptance of the offer by the employee and the price at which the shares have been offered.

There is no regular tax due on an incentive stock option (ISO) until the option is actually transferred (sold) by the employee for a price higher than the price at which the option was granted. The difference is treated as capital gains and is taxed accordingly. A disposition of an ISO is generally defined as any sale, exchange, gift or transfer of legal title of the stock (IRC section 424(c)(1)). Certain exceptions to this general definition are provided for under Section 424(c) of the IRC. These exceptions include a transfer from a decedent who held ISO stock to an estate, a transfer of ISO stock by bequest or inheritance, an exchange of ISO stock in a non-recognition transaction such as a reorganization, a transfer of stock between spouses incident to a divorce, a transfer of ISO stock into joint ownership, or a transfer of ISO stock by an insolvent individual to a trustee in bankruptcy. In such cases, there is no incidence of capital gains and thus no tax.

On the other hand, the tax incidence in case of NQSOs is greater. When the option is exercised, the employee has to pay normal taxes on the difference between the option price and the prevailing market price. Secondly, when these shares/stock is sold, there is an incidence of tax on capital gains (difference between the sale consideration and the prevailing market price as on the date of exercise of the option).

Pricing and other regulations governing incentive stock options:

For a stock option to meet the requirements of an "incentive stock option" in order to ensure that the employees benefit from a favorable tax treatment, the following requirement of Section 422 of the Internal Revenue Code (IRC) must be satisfied. These requirements are to be complied with not only at the time of grant of the option but right till the exercise of such option by the employees

- The option must be granted only to employee
- The stock option must be an option to purchase stock of the employer corporation or the stock of a parent or a subsidiary corporation.
- The stock may be capital stock of any class of the corporation, including voting and non-voting common or preferred stock. In addition using special classes of stock that are authorized to be exclusively issued and held by the employees are permissible
- The option must be granted under a written plan document specifying the total number of shares that may be issued to the top employees who are eligible to receive the option
- The plan must be approved of by the stockholders within twelve months before or after adoption of the plan
- This approval of the stockholders must comply with the charter, bylaws and state laws which regulate the stockholder approval required for issuance of corporate stock
- If there is no applicable authority, the plan must be approved by a majority of all outstanding voting stock (whether such votes are in person or by proxy) at a duly held stockholder's meeting with a quorum present, or by a method that would meet the applicable state law requirements regarding approval of actions requiring stockholders voting
- Each option must be granted within ten years of the earlier of the adoption or shareholder approval and the option must be exercisable only within ten years of the grant.

- The option price must equal or exceed the fair market value as on the date of grant. To determine the fair market value [7]of the underlying incentive stock option stock, the grantor corporation must make a good faith attempt to determine the fair market value (**FMV**). For stock that is not publicly traded, any reasonable valuation method may be used. Restrictions which are placed on stock are not to be considered, except when the restriction is one which will never lapse
- The employee must not at the inception of the option grant, own stock representing more than 10% of the voting power of all stock outstanding, unless the option price is at least 110% of the fair market value and the option is not exercisable more than five years from the time of the grant
- The incentive stock option agreement must specifically state that the incentive stock option cannot be transferred by the option holder other than by will or by the laws of descent and the option cannot be exercised by anyone other than the optionholder
- The statutory holding period in case of an ISO is the later of two years from the date of the granting of the ISO to the employee or one year from the date on which the shares were actually transferred to the employee, when he exercised the option.
- If the employee does not adhere to this stipulated holding period, enumerated above then such disqualifying disposition leads to a higher tax incidence in the hands of the employee. He is taxed on such disposition, first on the difference between the FMV as on the date of exercise of the option and the option price. This constitutes his ordinary income. Second, he is taxed on capital gains, which is the difference between the consideration received and the FMV as on the date of exercise of the option.

The employee stock option plan may include other provisions that are not required as long as such provisions are inconsistent with these requirements.

Constructive exchange:

Employers often include provisions enabling the employee to finance the exercise price. For example: the ISO plan can provide that the employee may pay for the exercise of his option with the stock of the company.

Many companies allow their employees to exercise stock options by tendering previously owned shares and cash in exchange for new shares. In a private letter ruling[8] , a corporation with an ISO plan and a NQSO plan was allowed to let its employees make a constructive exchange (not a physical exchange) of the shares already owned instead of mailing them to the corporation.

Illustration: Assume that Mr A, an employee owns 1,000 shares bought 5 years ago at the option price of US $ 5 per shares, when the stock was selling at US$ 7 per share. Mr A, has an option to buy an additional 5,000 shares @ US$ 10 per share and the market price currently prevailing is US$ 20 per share.

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[7] The relevant accounting norms and calculation of fair market value are discussed later in this article
[8] Source: Journal of Accountancy, October 1997, Private letter ruling number 9629028.

In a constructive exchange, Mr A will simply keep the original 1,000 shares and send in a check for US$ 30,000 :- { cost of new shares US$ 50,000 minus current fair market value of old shares US $ 20,000} and he will receive 5,000 additional shares.

Incentive stock option plan: If the 1,000 shares offered as payment are mature ISO shares and the new 5,000 shares are offered under an ISO plan, then Mr A will recognize no gain on the constructive exchange of 1,000 shares. Mr A will also recognize no income on exercise of his option.

Secondly, the 4,000 new shares will have a basis of US$ 30,000 (the cash price paid on exercise of the option) and a new holding period beginning on the day the option was exercised. The 1,000 original shares will have a carryover cost basis of US $ 5,000.

If the 1,000 shares offered as payment are not mature ISO shares, then Mr A will be taxed on US$2,000 (the original option savings of US $ 2 per share X 1,000 shares). Mr A will not be taxed on the pure appreciation of US$ 13,000 associated with the original 1,000 shares {current fair market value (FMV) of $20 per share minus FMV on the date of original purchase of US$ 7 x 1000 shares}.

Non qualified stock option plan: If Mr A possesses Non-qualified stock options to buy the 5,000 shares, he must recognize US$ 50,000 as ordinary income. Ie :{US$ 80,000 FMV of new shares minus US$ 30,000 being the cash paid on constructive acquisition}.No income is recognized on the exchange of the 1,000 previously owned shares for the 1,000 new shares.

Disclosure requirements:

The company has to disclose in its offer document, the number of shares which are reserved for issuance to eligible employees, directors and consultants upon the exercise of the stock options. The ESO, in general has to be approved of by the shareholders and adopted by the Board of Directors (**BOD**). This approval and adoption has also to be specified in the offer document, together with other details such as pricing, administration of the scheme, eligibility criteria et al.

Administration:

The ESO may be administered either by the BOD or by a committee (known as the Administration Committee, Compensation Committee etc) appointed by the Board for such purpose.

The powers given to such committee may vary from company to company. A typical authorization includes “ the power to determine, from among the persons eligible for grants under the Stock Incentive Plan (i) the individuals to whom grants will be granted, (ii) the combination of grants to the participants and (iii) the specific terms of each grant. The BOD retain the right to terminate or amend the stock incentive plan at any time, subject to the provision that such action will not adversely affect the right or obligation regarding any awards previously made under such plan, without the consent of the recipient. In the event of any changes in the capital structure of the company, such as a split up, the BOD are bound to make equitable adjustments to the outstanding unexercised awards so that the net value of the award remains unchanged.

Pricing:

The option exercise price of each option granted under the stock incentive plan is determined by the administrator, but in the case of an incentive stock option, it cannot be less than 100 % of the FMV of the underlying shares as on the date of the grant. On the other hand, if any employee of the company or any subsidiary owns or is deemed to own at the date of grant of shares of stock representing in excess of 10% of the combined voting power of all classes of stock of the company, the exercise price for incentive stock options granted to such employee may not be less than 110% of the FMV of the underlying shares on that date. These pricing norms are laid down by the IRC as explained above. The exercise price of a non-statutory stock option is also laid out by the IRC and is equivalent to at least 85% of the FMV as on the date of the grant.

Period of exercise of the option:

Incentive stock options are not exercisable beyond ten years from the date the option is granted. On the other hand, in case of an employee holding more than 10% of the combined voting power of all classes of stock of the company , the power to exercise is within five years of the date of grant of option. The right to exercise such option lapses, on expiry of this period, or earlier upon termination of the recipients' employment. No option is transferable other than by will or laws of descent and distribution. Further, a company may require that such option be exercised by the nominee or legal heir within a specified period of time.

Employee Stock Purchase Plan

Payroll deductions enable employees to pay for the stocks under this variant of employee stock option plans. While stock options are generally targeted at key employees, this mechanism covers all employees including blue collar workers.

Once again, the IRC has laid down rules and regulations governing the employee stock purchase plan (ESPP). If the following conditions are satisfied then the employee is entitled to tax benefits. Employees will not recognize ordinary income when the option is exercised, but will recognize such income on disposition of the stock at a later date.

- Only employees of the employer sponsoring the employee stock purchase plan and employees of parent or subsidiary company may participate in the plan
- To receive a favorable tax treatment, an employee can own no more than 5% of the voting power of the employer or 5% of the value of all shares of stock of the employer
- The plan must be approved of by the shareholders of the granting company within 12 months before or after the plan is adopted

- The stock for which the plan offers options must be the capital stock of the employer. This capital stock can be of any class, including voting or non-voting common or preferred stock. It may be treasury stock or stock of original issue. A special class of stock authorized and issued solely to the employee also would qualify as stock for this purpose
- All employees of the sponsoring employer must be included in the stock purchase plan. However, employees who have been employed for less than two years, employees whose customary employment is 20 hours or less per week, employees whose customary employment is for not more than five months in any calendar year and highly compensated employees (as defined in the IRC) can be excluded from participation in the plan
- The stock purchase plan must provide that no employee can accrue the right at any time to purchase stock of his employer at a rate which exceeds US$ 25,000 of the FMV of such stock (as on the day the option was granted) for each calendar year for which the option was outstanding.
- Pricing is one aspect where there is a key difference between ISOs and ESPP. Under the ESPP, the company can offer options with an option price of between 85% and 100% of the FMV of the stock, either at grant or exercise.
- Options granted under the ESPP must be exercised within five years from the date of the grant of option. The exercise price must be at least 85% of the FMV of the company's stock. If the option exercise is determined in any other manner such as a flat dollar sum, then it is imperative that the option be exercise within 27 months of the date of grant of option.
- The options granted under this plan, must not be transferable other than by will or by the laws of descent and distribution. Only the employee can exercise the option during his lifetime.
- The underlying stock in respect of the ESPP should be held for at least two years after the date of grant of option or one year from the date of transfer of the stock pursuant to the option.
- If stock is disposed off prior to the statutory period mentioned above, the employee recognizes at the time of disposition, ordinary income (difference between the FMV prevailing as on the date of exercise of the option and the option exercise price). Secondly, the capital gains constitutes the difference between the FMV of the stock as on the date of exercise and the actual consideration received on such sale or transfer.

The company can add additional terms and conditions to its ESPP, but these terms and conditions should not violate those laid down by the IRC. These terms and conditions including those laid down by the IRC have to be disclose in offer documents. Additionally, mention is also to be made of the quantum of shares which the company has reserved for ESPPs.

Eligible Directors' Stock Plan

Some companies offer a stock plan to their non employee directors. Non-employee directors, on the date of their initial election to the BODs, are entitled to opt for this scheme. The exercise price of the option is 100 per cent of the closing price per share as on the date of the grant of the option. Generally, directors are entitled to use previously acquired shares of the company's common stock to pay the exercise price of the shares purchased, provided that such shares (previously acquired) have been held for a certain period.

401(k) Plans

401(k) Plans are tax-qualified employee savings and retirement plan covering the employees of the company. These plans enable employees to defer part of their pay on a pre-tax basis into an investment fund set up by the company. The company, itself can match contributions made by the employees. There is a combined limit of 15% of the taxable limit that the company and the employee can together contribute towards this plan. Recently, in early 1997 this limit of 15% has been raised to 20%. However, this limit is further reduced by contributions to other tax-qualified retirement-oriented benefit plans. The trustees of the investment fund, set up by the company, at the direction of each participant invest the assets of the 401(k) Plan, into designated investment options. This plan qualifies for tax benefits under section 401 of the IRC. Contributions made to this plan and income earned on such contributions are not taxable until withdrawn. Moreover the contributions made by the company are tax deductible when made.

The company has to specify details of 401(k) Plans, if any, in its offer document. This plan however, has its own pros and cons. Investments under this plan are not restricted to the company's own stock. From the company's perspective, its own stock is one of the most cost-effective means of matching employees contributions. Funds are ploughed back into the company and further a tax deduction is available. On the other hand, this could be risky for the employees as it may not lead to diversification of the investment portfolio. Further it would dilute the holding of other stock holders.

Others

Besides the most popular types of employee stock option plans enumerated above, other plans also exist which do not satisfy the legal requirements to qualify as ISOs or ESPP. Consequently the employees cannot avail of any tax benefits. In simple words, such options are taxable in the hands of the employees as and when they are granted (if they have a readily ascertainable fair market value at this point of time). Else such options are taxed at the time of exercise. Under these plans, the eligible employees are given the option to purchase a certain number of shares of stock at a predetermined price. The option is exercisable immediately or after the passage of a certain period of time or on the occurrence of a particular event. Restricted stock option plans, phantom plans and share appreciation plans all fall under this category.

Restricted Property Plans

Stock received by an employee in connection with the performance of his services may be subject to certain restrictions which are imposed by the employer. For example, if there is a restriction that the employee will work for a stipulated period of time, the stock is known as restricted stock. If the employee resigns or his services are terminated prior to this period, then the stock is sold back to the employer at a formula price based on book value.

The tax treatment of restricted stock differs from stock which is not subject to any restrictions. The IRC distinguished between two kinds of restrictions -- those which may lapse during the period of ownership by the employee and those restrictions which never lapse.

In case of the former, the employee is taxed on the date of receipt of stock. In the other case, the taxable event is delayed till the restriction lapses. An election is available which minimizes the tax consequences in the hands of the employee. An employee receiving restricted stock may elect to have ordinary income element of restricted property close at the time the stock is transferred.

Closing the taxable event under IRC's section 83 gives the employee the chance to limit his ordinary income to the difference between the cost of the stock and the FMV of the stock on the date such stock is purchased. Later, any appreciation in the property after the date of transfer is potential capital gains which must be recognized when the stock is disposed of. The IRC section 83(b) election, must be made within 30 days after the transfer of property (stock) and once the choice is made it is generally irrevocable. However, if such property is forfeited by the company if the conditions are not met, then no deduction is available to the employee in respect of the tax already paid on recognition of ordinary income.

Stock Appreciation Rights (SARs)

In this case, the employee does not actually buy the stock of his employer company, but he profits from stock appreciation over a period of time. It gives the employee the right to obtain future appreciation without risking any capital. In fact, companies sometimes offer SARs in tandem with ISOs to enable employees to fund their option under the ISOs.

However in such cases, the SARs plan must meet the following requirements:

- The SAR must expire no later than the expiration of the underlying ISO
- The SAR may be for no more than 100% of the bargain purchase element of the underlying ISO
- The SAR is transferable only when the underlying ISO is transferable and subject to the same conditions
- The SAR may only be exercised when the underlying ISO may be exercised
- Further, the SAR may only be exercised when the market price of the stock exceeds the exercise price of the ISO

Illustration: Mr A is granted a one year SAR on 1,000 shares when the market price is US$2 per share. At the year end, the price rises to US$3 per share. The stock appreciation for the employee is thus US$1,000. If an ISO is granted along with the SAR plan, this US $ 1,000 can be used to exercise the option under the ISO. The only liability which the employee has to bear is the tax on ordinary income of US$ 1,000 (stock appreciation).

Phantom Stocks

Phantom Stock options offer employees a growth plan and / or a basic plan. Here the employee does not bear any risks associated writhe actual ownership, but he becomes the beneficial owner of such stock.

Under the growth plan, the employer company credits an employee account with hypothetical “phantom” stock. Further all dividends, bonus, stock splits attributed to such stock is also credited to the employees account. No tax is payable on such credit. However, at the end of the specified future period of time, or on cessation of employment due to death or retirement, the employee or his heirs/nominees are entitled to receive any appreciation in the stock value (difference between the FMV as on the date of the grant minus the FMV now prevailing). This appreciation may be paid in installments and can even be in kind, in the form of company stocks. Under the basic plan, the employee receives the dividend credited against the phantom stock standing to his account and also cash equivalent to the number of stock credited to his account. In this case, stock appreciation is ignored and a fixed sum is paid out against the phantom stock which has been credited over the years.

E. Securities Exchange Commission (SEC) disclosure rules for the corporate insider

The SEC recently made sweeping changes in disclosure requirements and relaxed these norms *vis a vis* employee stock option plans. It inserted a new Rule 16 b-3 on May 31, 1996 during the course of its final amendments to section 16 . Insertion of this new Rule has granted some degree of flexibility to employees covered by stock option plans to transfer their securities.

Earlier a corporate insider (officers and directors) had to conform to the six month rule, imposed by the SEC. If stock (including that acquired under employee stock option plans) was sold within six months of the date of grant of option, widespread disclosures had to be made. Moreover, the profits (referred to as “short swing profits’) if any realized on such transfer had to be forfeited and surrendered back to the company.

Overview of section 16

Section 16, which applies to officers, directors and principal shareholders (shareholders holding more than 10%) of a public reporting company, is designed to discourage corporate insiders from engaging in transactions in their company securities that present an opportunity for speculative abuse. Generally, section 16 imposes on the corporate insider the obligation to publicly disclose their holdings and transactions involving their company’s equity securities and to turn over to their company any short swing profits that they realize from trading in such securities.

Section 16(a) requires the corporate insider to file periodic reports with SEC, any exchange upon which his company's equity shares are traded and the company itself, to disclose holdings of and transactions in the company's securities.

Under the provisions of section 16(b), any corporate insider who realizes a profit from the purchase/sale or sale/purchase of equity securities of the company within a period of less than six months is presumed to have been trading on the basis of material, non public information and must disgorge such profits to the company.

New Rule 16 b-3

At the center of the 1996 amendment is SECs new approach for exempting transactions between a company and its officers/directors under Rule 16 b-3. This approach is based upon SEC's belief that the primary thrust of section 16 is to curb abuses related to market transactions rather than transactions that are primarily compensatory in nature. Thus, it now seeks to exempt transactions between a company and its officers/directors from the ambit of Section 16, unless the transaction allows the corporate insider the opportunity for speculative abuse, either because the transactions is with the market or is tantamount to a market transaction. Many employee benefit plans, such as stock purchase plans and other broad based tax qualifying plans are exempt from section 16 altogether as long as certain minimum conditions are met.

General Approach of New Rule 16b-3

Generally, a transaction between a company (including an employee benefit plan sponsored by the company) and its officers and directors will be exempt from short swing profit recovery provisions of section 16(b) if the transaction satisfies the conditions specified below:

i. routine non-volitional transactions pursuant to a tax conditioned plan (for example: 401K plan, a tax qualified profit sharing plan, section 423 employee stock purchase plan and an excess benefit plan will be exempt without any further consideration

ii. fund switching transaction or volational cash withdrawal from an employee security fund within a plan will be exempt if the election to engage in the transaction is at least six months after the last election to engage in an opposite way (purchase/sale) transaction under any company plan

iii. other acquisitions by an officer or director from his company including grants of stock options will be exempt upon satisfaction of any one of the following conditions :

- approval in advance of the transaction by the BOD
- approval in advance of the transaction by a committee of two or more non employee directors
- approval or ratification of the transaction by the company's shareholders
- satisfaction of a six month holding period following the date of acquisition

Elimination of the non transfer restriction will make it easier for corporate insiders to transfer derivative securities (including stock options) to third parties, without jeopardizing the exempt status *vis a vis* short swing profits. However, corporate insiders will continue to be subject to non transfer restrictions which may be imposed by the IRC and restrictive covenants of the plan itself.

F. New Accounting Norms

Stock options are viewed as an inexpensive benefit because they don't cost a business any cash or cause any charge to earnings. However they may dilute a company's stock if enough options are exercised, thus the Financial Accounting Standards Board (**FASB**) believes that the potential impact of stock options should be reported on a company's reports.

Recently in 1996, the FASB has issued statement number 123 on "Accounting for stock based compensation[9]" The new rules are effective for calendar year 1996; however, companies will be required to include information about SOPs granted in the previous year 1995.

Synopsis of FASBs statement number 123 "Accounting for stock based compensation[10]"

Disclosures	It requires disclosure of new employee stock options in the form of a note to the financial statements based on the fair value as at the date of the grant
Applicability	The new disclosures will be required in the financial statements for fiscal years beginning after December 15, 1995, with earlier application permitted.
Calculation of option values	The Black Scholes model is preferable for calculation of option values
Tools available	Present value formulas, normal probability distribution statistics and spreadsheets would be the tools available to calculate option values
Difficulties	Factors such as early option exercise, dividends and stock price volatility can make option values difficult to determine

[9] Source: Journal of Accountancy, January 1996
[10] Source: "Putting together the pieces", by James Mountain, Journal of Accountancy, January 1996

This standard encourages but does not require companies to account for stock based compensation awards based on their fair value at the date the awards are granted, with the resulting compensation cost shown as an expense on the income statement.

If they continue to apply current accounting requirements (*ie:* intrinsic value based methodology) companies will have to disclose in a note to the financial statements what the net income and earnings per share would have been had they followed the new accounting method.

Extract of FASB Statement no:123
Accounting for Stock Based Compensation[11]

Summary:

This statement establishes financial accounting and reporting standards for stock based employee compensation plans. Those plans include all arrangements by which employees receive shares of stock or other equity instruments of the employer or the employer incurs liabilities to employees in amounts based on the price of the employer's stock. Examples are stock purchase plans, stock options, restricted stock and stock appreciation rights.

This statement also applies to transactions in which an entity issues its equity instruments to acquire goods or services from non-employees. Those transactions must be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measured.

Accounting for Awards of Stock-Based Compensation to Employees

This statement defines a fair value based method of accounting for an employee stock option or similar equity instrument and encourages all entities to adopt that method of accounting for all of their employee stock compensation plans. However, it also allows an entity to continue to measure compensation cost for those plans using the intrinsic value based method of accounting prescribed by APB Opinion No:25, "Accounting for stock issued to employees". The fair value based method is preferable to the Opinion 25 method for purposes of justifying a change in accounting principle under APB Opinion No:20, "Accounting changes".

Entities electing to remain with the accounting in Opinion 25 must made pro forma discolors of net income and, if presented, earnings per share, as if the fair value based method of accounting defined in this statement had applied. Under the fair value based method, compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period.

[11] Source: Official release of FASBs statement no:123, Journal of Accountancy, January 1996

Under the intrinsic value based method, compensation cost is the excess, if any, of the quoted market price of the stock at grant date or other measurement date over the amount an employee must pay to acquire the stock. Most fixed stock option plans -- the most common type of stock compensation plans -- have no intrinsic value as on the date of grant, and under Opinion 25, no compensation cost is recognized for them. Compensation cost is recognized for other types of stock based compensation plans under Opinion 25, including plans with variable, usually performance based features.

Stock Compensation Awards Required to be settled by issuing equity instruments:

Stock Options:

For stock options, fair value is determined using an option pricing model which takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividends on it, and the risk-free interest rate over the expected life of the option.

Non-public entities are permitted to exclude the volatility factor in estimating the value of their stock options which results in measurement at minimum value. The fair value of an option estimated at the grant date is not subsequently adjusted for changes in the price of the underlying stock or its volatility, the life of the option, dividends on stock or the risk free interest rate.

Non-vested Stock:

The fair value of a share of nonvested stock (restricted stock) awarded to an employee is measured at the market price of a share of a non-restricted stock on the grant date, unless a restriction will be imposed after the employee has a vested right to it, in which case fair value is estimated taking that restriction into account.

Employee Stock Purchase Plan

An employee stock purchase plan that allows employees to purchase stock at a discount from the market price is not compensatory if it satisfies three conditions
(I) the discount is relatively small @ 5 % or less, in some cases a greater discount may also be justified as non compensatory
(ii) substantially all full time employees may participate on an equitable basis
(iii) the plan incorporates no option features such as allowing the employees to purchase stock at a fixed discount from the lesser of the market price at grant date or date of purchase.

In such cases, the discount from market price merely reduces the proceeds from issuing the related shares of stock.

Stock compensation awards required to be settled by cash

Some stock based compensation plans require an employer to pay an employee, either on demand or at a specified date, a cash amount determined by the increase in the employer's stock price from a specified level. The entity must measure compensation cost for that award in the amount of the changes in the stock price in the periods to which the changes occur.

Disclosures

This statement requires that an employer's financial statements include certain disclosures about stock based employee compensation arrangements regardless of the method used to account for them.

The pro forma amounts required to be disclosed by an employer that continues to apply the accounting provisions of Opinion 25 will reflect the difference between the compensation cost if any, included in the net income and the related cost measured by the fair value based method defined in this statement, including the tax effects, if any, that would have been recognized in the income statement if the fair value based method had been used. The required pro forma amounts will not reflect any other adjustments to reported net income, or if presented, earnings per share.

G. Listing requirements of the New York Stock Exchange

Stock exchanges have their own listing regulations which call for periodic disclosure to the stock exchange in the prescribed formats. These regulations also lay down the disclosure norms in annual reports and/or offer documents. Enumerated below are the rules and regulations laid down by the New York Stock Exchange.

Stock Option, Stock Purchase and Other Remuneration Plans Listing Process[12].

Para 703.09 of the listing manual enumerates the requirements to be fulfilled vis a vis stock options and other employee stock benefit plans.

- ***Shareholder Approval Policy***:

  The company's exchange representative has to be consulted for advice to decipher whether or not the Exchange's shareholder approval policy applies to a particular plan or arrangement. Para 312.00 of the listing manual enumerates the "Shareholder Approval Policy". It states that when : a stock option or purchase plan is to be established or other arrangement made pursuant to which stock may be acquired by officers or directors {except for warrants or rights issued generally to security holders

[12] Source: The New York Stock Exchange Listed Company Manual

of the company or broadly-based plans or arrangements including other employees (eg : ESOPs)}, shareholders approval is required. In a case where shares are issued to a person not previously employed by the company as an inducement necessary to his entering into an employment contract with the company, shareholder approval may not be required. Such approval, whenever required is a prerequisite for listing.

- ***Disclosure of Options, etc in Proxy statement***

In general (and without attempting to define what may be considered pertinent in all cases), concerning options or option plans presented for shareholder approval, a company should disclose as a minimum:

i. the intention to issue options
ii. the per share purchase price fixed by the options (or formula for determination of such price)
iii. the aggregate number of shares for which options will be issuable and/or the period during which the options may be issued
iv. the classes and number of persons to whom the options may be issued
v. the life of the options
vi. any information then available as to the conditions under which the options may be exercised
vii. terms of payment for shares covered by the options (including any amounts to be credited or debited in respect of the purchase price or balances owing by optionees)
viii. maximum number of shares which may be optioned to any one person
ix. provisions for amendment of the plan

It has been the experience of the Exchange that many company plans will provide for option committees to have broad based powers to amend the plan. These powers normally are not explicitly detailed. Although the Exchange realizes that a certain amount of flexibility is desirable, the company's shareholders should be provided with information as to major changes that could be approved of by the option committee without seeking further shareholders consent.

In respect to other types of stock purchase and remuneration plans the Exchange believes that all pertinent information in regard to the plans should be disclosed.

- ***Disclosure of Options etc in the Annual Report*:**

A listed company's annual report to the shareholders should disclose the following information as to its option plans:

i. Number of shares of its stock issuable under outstanding options at the beginning of the year
ii. Separate totals of changes in the number of shares of its stock under option resulting from issuance, exercise, expiration or cancellation of the options

iii. The number of shares issuable under outstanding options at the close of the year

iv. The number of unoptioned shares available at the beginning and at the close of the year for the granting of options under any option plan

v. any changes in the exercise price of outstanding options, through cancellation and reissuance or otherwise, expected price changes resulting from the normal operation of anti-dilution provisions of the options

- ***Filing a Listing Application Relative to Stock Option, Stock Purchase or Other Remuneration Plans***

It is recommended that an application for listing of unissued shares in connection with a stock option, stock purchase or other remuneration plan be filed as soon as possible after all the required corporate and shareholder action has been taken.

A listing application would also have to be filed if a company significantly amends a plan covered by a previous listing application. The application must cover all the shares that would be subject to issuance under the amended plan. The shares reserved for issuance under the old plan would be delisted. Generally, a listed application would have to be filed if the amendment was of such significance that the company was required under the terms of the plan to have the amendment approved of by the shareholders.

- ***Supporting Documents***

The following documents must be filed in support of the listing application:
Opinion of counsel
Plan document (copy of plan or prospectus as appropriate)
Current form of listing fee agreement (if not previously filed)
Current form of listing agreement (if not previously filed)
Prospectus (12 final copies)

Thus, the listing requirements are exhaustive enough to provide the stock exchange and the investors adequate details of the employee stock option plans of a company.

The contents of this paper should not be construed as legal opinion or professional advice.