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Having Your Cake and Eating it Too: The Cashless Option Exercise

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Equity-based compensation plans, or stock option plans, have long been used as a mechanism for getting key bank employees, executives and directors to "think as owners." In some sense, stock options are a way of tying employee wealth more directly to shareholder wealth and are intended to motivate employees to increase shareholder value. However, many bank employees and many executives cannot afford to pay out the cash necessary to exercise their options prior to expiration, and this is where the "cashless option exercise" comes into play.

There are basically three different ways that a plan participant can exercise their option without coming up with cash out-of-pocket to do so. Each method has its own advantages and disadvantages. However, certain situations may dictate one over another to avoid running afoul of securities laws as discussed herein. The three methods of cashless option exercise are:

- ***The "Stock-for-Stock" Exercise***
  If the plan participant already holds a sufficient quantity of stock in his or her investment portfolio with built-in gains, some equity compensation plans allow them to turn in some of those shares to cover the option exercise. To complete this cashless exercise, the participant turns in enough shares at their current market value to "pay" the exercise price on the option shares, thereby exercising the option in a cashless manner. However, many employees do not have large personal reserves of stock to use as payment for their options, often limiting the usefulness of this alternative.

- ***Netting Transaction***
  Some equity compensation plans allow for "netting" of the spread between the exercise price and the market price to enable the exercise of a certain quantity of the option shares without depleting personal cash. Using the market value at the time of exercise, the company merely reduces the number of shares issued to the participant sufficient to cover the exercise price and issues the balance of the shares with no cash outlay. This approach enables the participant to retain some portion of the shares, but the plan must contain the appropriate language and the options must be sufficiently "in the money" to make it feasible.

- ***Broker-Assisted Cashless Exercise***

> Probably the most common form of cashless exercise is where the participant engages a broker to loan the money to pay the option exercise price, and then the broker sells enough of the shares received on exercise to cover the amount of the loan, plus any transaction costs, with the participant receiving the balance. This method has the obvious advantage of requiring no cash outlay by the participant and no special language is required in the plan to permit this type of transaction.

However, insider trading issues can lurk in the weeds with a cashless option exercise, particularly with the broker-assisted transaction. While option exercises are typically exempt from scrutiny[1], the broker-assisted transaction involves a simultaneous sale "in the market" on behalf of the participant which could raise insider trading issues under the right facts and circumstances. Particularly troublesome situations could arise where the participant seeks to exercise stock options during a company's regular quarterly blackout period near the end of a quarter and prior to an earnings release, or at a time when the participant is aware of other material nonpublic information. It is important to avoid these traps by maintaining comprehensive and up-to-date insider trading policies within the company and by providing the proper oversight and guidance to participants in following the policies. Finally, equity based compensation plans should be periodically evaluated for compliance and kept up-to-date with flexible alternatives to suit your particular company's needs and circumstances. In short, any of the three cashless exercise alternatives may allow your plan participants to have their cake and eat it too – just be careful.

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[1] This is not always the case, see *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 856-57 (2d Cir. 1968), finding directors violated Rule 10b-5 by accepting a stock option award because they failed to disclose information about drilling results to the board or to the board's stock option committee.

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