

Indexed Stock Options: Sometimes Change is Good



CJ Van Ostenbridge and Jon Burg









December 2019

Introduction

Time-based stock options remain a vital component of executive compensation plans, even as they have fallen out of favor as a broad-based vehicle outside of start-ups and the life sciences industry.

Stock options have a variety of pros and cons just like any equity vehicle.

Is there a way to improve the design of an option to retain the strengths of traditional options while addressing the weaknesses? The answer is a resounding yes, an Indexed Option. And it is the perfect time for companies to consider granting them.

Pros	Cons
 Aligns option holders with long-term interests of shareholders	 Value delivered to option holder is highly influenced by bull markets or recessions
 Highly leveraged	 Can fall underwater
 Employee controls timing of exercise and taxable event	 No consideration to relative performance
 Longest-term equity award	

(Re)introducing Indexed Options

An Indexed Option looks almost identical to a traditional option except that the strike price is not fixed at grant. Instead, the strike price is defined as a function of the grant date stock price and the return of an Index over the life of the Option.

The table to the right shows how the strike price moves for an option that was granted at \$10.

- **Example 1:** The strike price changes to \$12 since the Index increased 20%.
- **Example 2:** The strike price changes to \$6 since the Index decreased -40%.

	Example 1	Example 2
Stock Price at Grant	\$10.00	\$10.00
Index Return	+20%	-40%
Strike Price at Exercise	\$12.00	\$6.00

The movement of the strike price ultimately impacts the value to the option holder at exercise.

Continuing Example 1 from above and assuming the stock price of the issuing company is \$15 at exercise, we see that the **Traditional Option is more valuable than the Indexed Option** (\$5 vs. \$3). The increase in the Index's return also increased the strike price for the Index Option.

Continuing Example 2 from above and assuming the stock price of the issuing company is \$8 at exercise, we see that the **Indexed Option is worth \$2 while the Traditional Option has no value**. The return of the issuing company was negative, but the negative return of the benchmark Index was even greater.

	Traditional	Indexed
Example 1		
Stock Price at Grant	\$10.00	\$10.00
Index Return	n/a	+20%
Strike Price at Exercise	\$10.00	\$12.00
Stock Price at Exercise	\$15.00	\$15.00
Value at Exercise	\$5.00	\$3.00
Example 2		
Stock Price at Grant	\$10.00	\$10.00
Index Return	n/a	-40%
Strike Price at Exercise	\$10.00	\$6.00
Stock Price at Exercise	\$8.00	\$8.00
Value at Exercise	\$0.00	\$2.00

The value delivered to the option holder at exercise reflected both the absolute performance of the company and the performance relative to the benchmark Index.

Why Didn't Indexed Options Work Before?

Indexed Options never gained a foothold in the US because the potential for the strike price to drop below the grant price caused two tax problems:

1. **Section 162(m):** Stock options with a strike price lower than the stock price at grant would not be considered performance-based awards under Section 162(m).
2. **Section 409A:** Stock options with strike prices below the grant price would be considered nonqualified deferred compensation under IRC Section 409A. Therefore, it would be subject to a 20% excise tax if the award holder can control the timing of distribution (i.e., exercise).

The Tax and Jobs Act passed in December 2017 eliminated the performance-based equity exclusion under 162(m) which removed the more significant barrier for Indexed Options. Additionally, an Indexed Option can comply with 409A and avoid the excise tax if the distribution of the deferred compensation (in this case, the exercise of the option) occurs at a predetermined time or schedule.

Key Design Decisions

There are several design decisions a company considering Indexed Options will need to evaluate:

- **Vesting:** The vesting period of an Indexed Option can be defined to match the goals of the company and will likely match the vesting period of other time-based options. However, Infinite Equity recommends reducing the number of tranches due to the Expense Recognition treatment discussed in the Accounting Considerations section.
- **Benchmark Index:** Choosing the Index is arguably the most critical decision. Infinite Equity believes that industry-focused indexes will be appropriate for most companies, but broad-market indexes may be appropriate for a specific subset.
- **Indexing Approach:** The strike price of an Indexed Option is tied to the return of a benchmark Index. However, the mechanics of that indexing could take several forms:
 - **Fully Indexed:** The strike price is adjusted on a “1-for-1” basis compared to the return of the benchmark Index. Every 1% change in the return of the benchmark Index results in a 1% change in the strike price.
 - **Partially Indexed:** Every 1% change in the return of the benchmark Index results in <1% change in the strike price. For example, a 10% increase in the benchmark Index may result in a 5% increase in the strike price.
 - **Collared Approach:** The change in the strike price may be capped at a certain level (e.g., +/- 25% from original stock price).

Type of Option	Stock Price at Grant	Benchmark Index Return	Indexing Approach	Strike Price
Traditional	\$10.00	n/a	n/a	\$10.00
Fully Indexed	\$10.00	30%	100% Indexing, uncapped	\$13.00
Partially Indexed	\$10.00	30%	50% Indexing, uncapped	\$11.50
Collared Indexed	\$10.00	30%	100% Indexing, capped at 25%	\$12.50

- **Settlement Period:** As mentioned above, the settlement time of an Indexed Option must be fixed as of the grant date. Settlement times will likely range from three to seven years from grant and could occur at one time (100% on the five-year anniversary of grant) or staggered over multiple periods (one-third on each of the third, fourth, and fifth anniversaries of the grant date).
- **Termination Provisions:** If employees terminate after the vesting period has completed but before the settlement date, companies will need to decide whether the options should settle upon termination or according to the original schedule.

Accounting Considerations

There are two key differences between the accounting treatment for Indexed Options compared to time-based options.

1. **Valuation Model:** The award contains a Market Condition as defined by ASC Topic 718 since value is dependent both on the return of the underlying share and the return of the benchmark Index. Therefore, it must be valued using Monte Carlo simulation or a lattice-based model.

The fair value for Indexed Options will generally be lower than Traditional Options with the same exercise assumption. The table to the right shows the fair value of an Indexed Option with exercise occurring five years from grant and assuming the benchmark Index has a volatility of 20%.

Lower volatility and higher correlation will typically increase the magnitude of this fair value discount. This would result in lower compensation expense (if grant size is fixed) or more options granted (if the award sized is determined using fair value).

		Potential Fair Value Savings with Indexed Options			
		Issuing Company Volatility			
		20%	30%	40%	50%
Correlation to Benchmark Index	0.30	-5%	-10%	-10%	-9%
	0.40	-12%	-15%	-14%	-12%
	0.50	-19%	-21%	-19%	-16%
	0.60	-28%	-28%	-24%	-20%
	0.70	-37%	-36%	-30%	-24%

2. **Expense Recognition:** Expense for Indexed Options will need to be accrued using the “accelerated” attribution method since the award is considered a Market Condition. The expense for each tranche is recognized over the period in which performance is measured.

Conclusion

The time for Indexed Options is now. The barriers that used to stand in the way have been eliminated. In an equity compensation environment that continues to emphasize long-term alignment with shareholders, relative performance, and value creation above the broader market, Indexed Options check a most boxes while retaining much of the upside and simplicity of Traditional Options.

Author Information

Please don't hesitate to reach out to either of the authors below with questions or if you would like further information.

CJ Van Ostenbridge, CEP

Director

cj@infiniteequity.com

+1.610.888.9339

Jon W. Burg, FSA, CEP

Partner

jon@infiniteequity.com

+1.415.205.9534
