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Tuning Up Stock Option Grant Practices

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Stock option grant practices have been the subject of recent guidance from the Securities and Exchange Commission (SEC), and continue to be scrutinized by various parties for compliance with the tax requirements of the Internal Revenue Service (IRS). If stock options are an important part of your incentive compensation programs, this may be a good time to review and tune up your stock option grant practices. Here are some thoughts on best practices for both privately held and publicly traded companies:

1. Timing of grants and setting the exercise price

One of the basic requirements for most stock options granted in the United States, to receive the desired tax treatment, is that the exercise price be set no lower than the fair market value of the underlying stock on the date of grant. Some suggestions for best practices in making grants within this framework are:

- *No "backdating" of stock options (applies to both privately held and publicly traded companies).* Backdating refers to the practice of granting a stock option with a grant date earlier than the date of on which the stock option is approved or other corporate formalities are satisfied. Backdating was sometimes used in years past to attempt to set the exercise price of options using a lower stock value as of an earlier date than the approval date. However, the practice did not comply with tax rules and typically led to accounting irregularities, so it is effectively not permitted. In the current context, backdating issues still sometimes arise when a company has promised an option to a newly hired employee, but does not complete the approval process until sometime later—believing that it should date the option as of the new hire's start date and treating it as having an earlier grant date. This should be avoided. The company can give the new hire vesting credit toward the stock option's vesting schedule from the employee's start date, but for all other purposes, it should not treat the option as being granted prior to the date on which the required approvals have been obtained.

- *Exercise price should not be lower than the fair market value on the date of grant (applies differently to privately held and publicly traded companies).*

    - *For privately held companies*: The tax rules on deferred compensation (Code Section

409A and the related regulations) and on statutory or incentive stock options effectively prescribe permissible methods of determining the fair market value of stock for purposes of setting the exercise price. A failure to follow these methods can result in potential exposure to penalty taxes and other adverse tax consequences. The best practice is typically an independent appraisal, sometimes known as a “409A valuation,” which receives a presumption in its favor. The regulations also permit certain other reasonable valuation methods, such as a formula-based valuation, but they suggest that a value calculated with respect to a date that is more than 12 months prior to the grant date should not be relied upon to set the exercise price of the stock option. Even for early-stage companies, it is important to ensure that an appropriate valuation method is used to establish the exercise price of stock options.

  - *For publicly traded companies*: In November 2021, the SEC issued a staff accounting bulletin providing guidance on accounting for stock option grants that were considered “spring loaded” – that is, granted at a time when the existence of positive material nonpublic information about the issuer may mean that the stock price is lower than it would have been if all material information were public. The bulletin suggests that option grants made while a company is in possession of material nonpublic information – for example, during an insider trading blackout period – could come under scrutiny if there is no adjustment made to the grant date fair value to take into account the potential impact of the material nonpublic information on the stock price. Public companies may wish to evaluate their grant timing practices or policies to determine whether the grants generally fall during blackout periods, and if so, whether to consider changing their practices or policies so that grants occur during open trading windows

2. Required approvals

- *Board-level approval and delegation (applies to both privately held and publicly traded companies).* Board-level approval of equity compensation, including stock options, is generally required to satisfy corporate law requirements. Some companies will seek to delegate granting authority to an officer, such as the Chief Executive Officer. However, under some states’ laws, this may be permissible only if the delegation includes specific parameters, such as a maximum number of shares that may be issued, the minimum consideration that must be received and the period during which the awards may be granted, or if the Chief Executive Officer is a member of the Board and can serve as a one-member committee of the Board. Before delegating award authority to an officer, companies should ensure that such delegation is permitted by the laws of their state of incorporation and their bylaws and articles, or certificate of incorporation.

- *Committee approval under stock exchange rules and Section 16 of the Exchange Act (applies to publicly traded companies).* For publicly traded companies, the national securities exchanges, such as the NYSE and NASDAQ, impose specific approval requirements for listed companies. These generally mandate that an independent compensation committee approve, or recommend to the full Board for approval, the compensation, including equity compensation, of the executive officers.

  In addition, public companies should be mindful of pre-approval requirements that must be satisfied to exempt transactions from potential short-swing profits matching under Section 16(b) of the Securities Exchange Act of 1934. The short-swing profits matching rules under Section 16(b) require insiders, including officers, of public companies to disgorge any profit they make on a sale and a purchase, or a purchase and a sale, of the company's stock within a six-month period. Pre-approval by a committee consisting of two or more non-employee directors or by the full Board can exempt transactions between the insider and the company, such as an option grant or an option exercise, from these short-swing profits matching rules.

3. Other checklist items

A few other sometimes-overlooked items that belong on any grant practice checklist include:

- *Check compliance with equity plan terms (applies to both privately held and publicly traded companies).* Ensure that any proposed option grant complies with the terms of the applicable equity plan by checking the overall share reserve to ensure there are adequate shares, verifying the remaining term of the plan to ensure it is still active and confirming any other limits, such as per participant limits on specific award types.

- *Check compliance with incentive stock option rules (applies to both privately held and publicly traded companies).* For incentive stock options, consider whether the grant needs to comply with the special requirements for 10% or greater stockholders and whether the $100,000 limit on annual vesting will be exceeded based on the value of the options being granted and the vesting schedule.

- *Securities law compliance (applies differently to privately held and publicly traded companies).*

    - *For privately held companies*: Ensure that the requirements of Rule 701 under the Securities Act of 1933 are being complied with, including delivery of the plan and, if the grants exceed $10 million in any 12-month period, delivery of financial statements and risk factors. State securities ("blue sky") laws also should be reviewed to ensure that any filing requirements are satisfied.

    - *For publicly traded companies*: Ensure that the prospectus is delivered to the option recipients prior to exercisability and that, if the option award recipient is an insider, a Form 4 is filed within two trading days of the grant.

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