

New option for employee options

Recent SEC rule change allows unexercised ones to act as collateral in hedging transactions

By Robert N. Gordon

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The recent SEC rule change allowing unexercised employee options to act as collateral for listed publicly traded options is good news for holders of employee options.

Until now, if the holder of employee options sold exchange traded calls on the underlying stock, those call options were considered to be written naked. Naked calls need a lot of collateral as margin, and if the stock price increases, they require more margin. If the options are considered to be covered-call options, as the recent rulings state, then only the unexercised options are necessary as collateral.

Kudos to the folks at iOptions Group LLC in Chicago, who have been working on this for 10 years.

The change potentially could clear the way for employees to sell covered calls in the market and lock in some of the unrealized gains in their unexercised employee options. Employees holding stock options can now more easily capture the income available through the sale of call options. The time premium associated with options is normally not available to employees and is automatically lost upon early exercise of the employee option. Note that the Securities and Exchange Commission will allow this structure only if the employee options are vested.

I foresee two potential stumbling blocks to implementation.

First, given the uncertificated nature of employee stock options, employees will need the assistance of their employers to complete transactions. Before the unexercised employee options can act as collateral, the employer must sign an agreement that contracts the company to deliver shares (if the employee exercises the option) only to the broker-dealer, not to the employee. This agreement will also stop the unexercised options from being pledged more than once.

The employer also agrees to waive any forfeiture conditions that otherwise might apply to the employee options, as well as any transfer restrictions that would preclude pledging of the employee options. In addition, the employer will represent that the employee options are covered by an effective registration statement on Form S-8. If the registration statement becomes ineffective, the employer agrees that it will notify the broker-dealer immediately. Until this process becomes standard operating procedure, many employers are likely to balk at these obligations.

The second stumbling block is tax.

The majority of value in employee options is in non-qualified stock options that give rise to ordinary income when exercised. The potential problem is a whipsaw if the underlying shares increase after the call options are sold. As the stock increases, more ordinary income will be generated upon exercise of the employee options. The economic trade-off is a corresponding loss in the listed-call options — a capital loss. The combination of large amounts of capital losses and a like amount of taxable ordinary income can be deadly to those without capital gains.

We've written before on the possibility of an individual's utilizing Internal Revenue Code Section 1221, which was enacted so that corporations hedging business risks in the normal course of their business aren't saddled with capital losses when a business hedge goes against them. The question is whether an individual can make a 1221 election when placing a hedge.

It is rumored that a bank re-requested a private ruling on this question but withdrew that request upon learning that it was likely to be denied.

Some comfort has been taken from a private-letter ruling that provided guidance about the application of Section 1221 when a derivative is used to hedge in the context of employee compensation. This ruling involved an employer that offered employees deferred compensation based on the performance of certain mutual funds. The employer identified the corresponding investment as hedging transactions under Section 1221. The ruling held that the deferred-compensation obligation was an "ordinary obligation" and that the investment contracts qualified as hedging transactions for purposes of Section 1221.

The ruling also stated that the employer's deferred-compensation liability is an "ordinary obligation" under Section 1221. Although employee options are an asset, not a liability, in the hands of an employee, the same analysis could arguably apply.

Robert N. Gordon is chief executive of Twenty-First Securities Corp. of New York and an adjunct professor at New York University's Leonard N. Stern School of Business. He can be reached at bob@twenty-first.com.