Chapter 1

Introduction

If you are reading this book, it may be safe to assume you are a holder of ESOs, or advise others who hold them. As you will soon learn, there are choices available to ESO holders that go far beyond the traditional premature exercise plan offered by most financial advisers.

Consider for a moment an example where your ESOs have appreciated in value and you are faced with the choice to exercise them and then sell the stock, on the one hand, or hold on to the ESOs with all the associated risk in the form of possibly giving back gains resulting from the stock declining, on the other hand. Now imagine further that your financial adviser—and maybe you don't need to imagine this—has suggested the early exercise route, resulting in long stock positions that you will then liquidate, to lock in value, and then diversify through purchase of a basket of mutual funds. These are common choices made by many ESO holders and may be one faced by you—not surprising, given that most conventional wisdom dictates this route. Perhaps you are grappling with this question right now. There are, however, other choices available to you.

The central thesis of this book is based on the idea that ESOs have a substantial value on grant day, which is the day they are issued to the employee or executive, and that premature exercises of these ESOs should be avoided because it sacrifices that value, known as time premium or extrinsic value. Avoiding premature exercise is crucial if you plan to maximize the long-term potential value of ESOs.

Grant Day

The day ESOs are issued to the employee or executive.

When ESOs are exercised prematurely, a large portion of the value (in the form of time premium) is sacrificed to the company granting them, and another part is paid to Uncle Sam through an early tax burden. Time premium can be substantial, depending on how much time remains on the ESOs and what levels of volatility exist in the underlying stock at the time. This becomes clear in the example presented below, where the grantee, who prematurely exercised his ESOs, realized net proceeds (after taxes) of less than 50 percent of the theoretical value of the ESOs he was holding! The lost value came from two sources—from time premium forfeiture and the early exercise tax liability.

Assume that the exercise price is $20 on an ESO and that the stock price on the grant day was $20 with 4.5 years remaining until expiration. While we need to make some assumptions about volatility and interest rates, they will not alter the basic outcome. If the grantee exercises ESOs at 100 percent above the strike price (i.e., at $40), the net proceeds upon exercise of the ESOs and sale of the acquired stock (1,000 shares in this case) would be $12,000 after taxes. But the theoretical value of the options prior to exercise was $24,526. The lower value resulted from $8,000 in taxes due upon exercise and $4,526 in time premium that was forfeited, giving a total value lost of $12,526. *Thus, over 50 percent of the ESOs' value was lost due to early exercise.* Yet strategies can be deployed for avoiding this, and more importantly producing a superior tax-adjusted outcome.

Clearly, delaying tax payments and capturing more of the time premium otherwise lost upon early exercise is going to make for better management of your portfolio. As you will see in this book, it is possible through use of hedging with listed calls and puts to set a floor for the expiration value price of your ESOs should they expire out-of-the-money, while at the same time you preserve potential for upside gain. This is as good as it gets with options.

Tip

Delaying tax payments and capturing more of the time premium otherwise lost upon early exercise allows you to better manage your portfolio. Through the use of hedging with listed calls and puts, it is possible to set a floor for the expiration value price of your ESOs should they expire out-of-the-money.

With the preceding example as the key objective to keep in mind, this book guides you through the steps needed to avoid the trap of early exercise. By offering the best available strategies to manage (and hedge) ESO grants, this book enables grantees to reduce risks while maximizing ESO value and keeping tax liability to a minimum.

To provide the proper background, we present a full explanation of all the essential ESO concepts, including definitions of technical terms. This is followed by contrasting ESOs with exchange-traded (i.e., listed) options, pointing out their differences and similarities. Since hedging of ESOs is done with listed options, it is necessary to get a solid feel for the basics of these often misunderstood trading vehicles.

With the necessary understanding of both ESOs and exchange traded options, you'll get introduced to the subject of ESO risk and reward scenarios, including the important issue of risk from premature exercise and early withdrawal from an IRA. This is followed by a detailed discussion of tax liability, including issues surrounding the so-called IRS Straddle Rule, the Constructive Sale Rule, the Wash Sale Rule, IRS Section 1221 and the tax implications of early exercise versus proper hedging of ESOs with exchange traded options.

The emphasis throughout this book is not on the design of the company's options plan or the options agreement, except to the extent that the plan impacts the grantees. That said, this is the only book that explains and promotes strategies involving the selling of exchange-traded calls and buying exchange-traded puts to manage ESO positions. Ample use of case studies using exchange-traded call and put options provides an accessible vehicle for understanding the hedging strategies that are aimed at efficiently achieving risk reduction while preserving ESO value. Whether a holder of ESOs or advisor to ESO holders, we trust you will find this book offers a valuable new way of thinking about ESOs and their potential value.