

Chapter 1

Stock Options: What You Need to Know Right Off the Bat

In This Chapter

- ▶ Knowing the basics of stock options
 - ▶ Figuring out why companies give employees stock options
 - ▶ Knowing what happens when you receive stock options
 - ▶ Understanding the two main kinds of stock options
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How's this for a new show hosted by Regis Philbin: "Who Wants to Be a Stock Options Millionaire?"

Forget about athletes, actors, and musicians. Throughout the 1990s, the world watched entrepreneurs like Bill Gates (co-founder of Microsoft) and Larry Ellison (founder of Oracle) become billionaires, largely because of their holdings in the companies they founded. Many people were even more enthralled by the legions of plain old regular employees like the "Dellionaires" — workers at Dell Computer who became millionaires from the spectacular rise in their company's stock throughout the decade — whose good fortunes convinced so many others that employment-driven wealth was just around the corner and achievable by almost everyone!

Just because you go to work for a company that gives you stock options doesn't mean you'll automatically become wealthy — but it *might* happen. This chapter explains how stock options work, why your employer might give you stock options, and how you *might* profit from those options.

Understanding Stock Option Basics

Stock options are actually very complex: You'll face many challenges ranging from managing your personal financial portfolio, to taxes, to trying to determine whether or not you should remain at a company where you hold stock options. Don't worry. I address all of these issues in subsequent chapters

throughout this book and make the whole process a lot less intimidating. For now, however, just concentrate on understanding the most basic aspects of stock options, as I discuss in this section.

Knowing what stock options are

A *stock option* is the right to purchase a specified number of shares of a company's stock at some point in the future at a contractually specified price — rather than whatever the stock price will be on that future date. And, if the fates smile upon you, that contractually specified price will be lower — hopefully *much* lower — than the market price for the stock on that future date, meaning instant profit for you.

For example, suppose that you begin a new job at GreatPlaceToWork.com as a software developer. In addition to your starting annual salary of \$50,000, you also receive a *stock option grant*, which is a legal agreement between you and your employer. This particular stock option grant gives you the right to purchase 10,000 shares of GreatPlaceToWork.com stock at the price of \$3 per share.

At some point in the future — say, in five years — GreatPlaceToWork.com has done fantastically well, and the stock price is \$103 per share. Because of your stock option grant, you could buy 10,000 shares of GreatPlaceToWork.com stock at only \$3 per share, turn right around and sell those 10,000 shares for \$103 each, and make a gross pre-tax profit of \$100 per share — or \$1 million!

You can substitute the term *employee stock options* for the more generic phrase *stock options* for almost all of the discussion throughout this chapter and this entire book. You will almost always find yourself holding stock options as a result of being employed at a company that has a policy of issuing stock options to its employees, including you.

I will specifically note when I am referring to stock options issued to individuals who aren't actually employees of a company. For example, Chapter 4 discusses stock options owned by investors and members of your employer's Board of Directors — people who may not actually be employees, even though they are associated with your company. And in Chapter 19, I'll discuss the now-passé phenomenon of using stock options as a form of currency in exchange for advertising services, consulting work, or leasing office space. For the most part, stock options held by non-employees work the same as employee stock options that you and your fellow workers hold. So while it's safe to think of the terms *employee stock options* and *stock options* as interchangeable, I'll explicitly call your attention to any differences.



Other types of stock options

Stock options issued to employees, Board of Director members, and others with some sort of relationship to a company are *not* the same as *publicly traded stock options*, which you may have heard about or have had some experience with. You can find publicly traded stock options along with the stock price listings in *The Wall Street Journal* or the financial pages of a major newspaper like *The New York Times*.

There are two types of publicly traded stock options:

- ✔ *Call options* (or *calls*) allow the holder to purchase shares of stock at a predetermined price, even if the current market price of the stock is higher than that predetermined price.
- ✔ *Put options* (or *puts*) allow the holder to *sell* (rather than buy) shares of stock at a predetermined price, even if that price is higher than the current market price of a stock.

Call options work much the same way as employee-oriented stock options, with one major distinction between the two. Calls — like puts — are *publicly* traded, meaning that anyone can buy or sell them. In contrast, employee-oriented stock options are usually *not* marketable, meaning that you're contractually forbidden from selling your stock options to someone, nor can you purchase someone else's stock options.

Calls and puts are a complex enough subject, so all you need to remember is that the types of stock options we discuss in this book are *not* the same as publicly traded stock options. So when you hear phrases such as “covered calls,” “straddles,” and “naked puts” (don't ask!) in reference to stock options, then it's the publicly traded stock options — not the subject of this book — that someone is talking about.

Knowing how stock options work

This section discusses the basics of how stock options work and what happens when you receive stock options.

As we previously mentioned, when your employer gives you stock options, you formally receive a legal document called a *stock option grant*. The stock option grant contains several very important details about the stock options, including:

- ✔ **The strike price.** The price at which you can purchase shares is known as the strike price of your options. No matter how high your company's stock price goes from that day forward, you will always be guaranteed the right to purchase shares of stock at the strike price specified in your stock option grant. (In the GreatPlaceToWork.com example earlier in

this chapter, the strike price specified in the stock option grant is \$3 per share.) Sometimes, a stock option grant will use more generic language such as *option price* or *exercise price*, but the street slang is “strike price.” Note that in your stock option agreements, you’ll usually find the term *option price* or *exercise price* rather than *strike price*, but in job offer letters and informal communication with a prospective employer, you’ll more commonly see the *strike price* term used.

- ✔ **Number of shares.** Sure, it would be great if you could turn around and say, “Ok, I want to purchase 1 million shares — no, make that 2 million shares — at my strike price,” after your company’s stock triples or quadruples in price. Unfortunately, stock options don’t work that way. Your stock option grant tells you the maximum number of shares you can purchase. (In the GreatPlaceToWork.com example from earlier in this chapter, the maximum number of shares specified is 10,000.)
- ✔ **The vesting schedule.** Suppose that you start working at GreatPlaceToWork.com, receive your stock option grant for 10,000 shares at a strike price of \$3.00, and three months later the company’s stock price goes up to \$13 per share. Could you immediately buy 10,000 shares at \$3 each and sell them for a profit of \$10 each (\$13 minus \$3), pocketing a quick \$100,000? Most likely not, because of the *vesting schedule* specified in your stock option grant.

The term *vesting* is a commonly used term in finance and business. In the case of stock options, the vesting schedule specifies a period of time over which the shares of stock represented by the option grant actually become available to so that you can exercise your options (see “Exercising Your Stock Option(s)” later in this chapter for more information). A common vesting schedule for stock options is four-year *cliff vesting*, meaning that the number of shares specified in your agreement become available to you in equal increments, spread out over four years. So in the GreatPlaceToWork.com example, the 10,000 shares would vest as follows:

- 2,500 shares (25 percent) would vest exactly one year after the date of the stock option grant.
- Another 2,500 shares (25 percent) would vest exactly two years after the date of the stock option grant, meaning that halfway through the four years, 50 percent of your stock option grant has vested.
- Another 2,500 shares (25 percent) would vest exactly three years after the date of the stock option grant — meaning that 75 percent of your grant is now vested.
- The final 2,500 shares (25 percent) would vest exactly four years after the date of the stock option grant, completing the four-year vesting period.

You might come across other vesting schedules, such as three-year vesting or perhaps a variation on the four-year vesting previously described, in which after the first 25 percent of your stock option grant vests on the one-year anniversary, the remaining 75 percent vests in equal monthly increments over the remaining three years rather than on successive anniversary dates. In Chapter 5, we talk more about vesting schedules.

- ✔ **Expiration date.** Stock option grants don't last forever, unfortunately. Typically, the grant expires ten years after the date of the stock option grant.
- ✔ **Details, details, details.** The strike price, number of shares, vesting schedule, and expiration date are the most basic details that describe your potential gains from your stock options and the time frame in which those gains might occur. However, like most legal documents, stock option grants contain many more details that cover just about any situation that might occur during the course of your employment, and how your stock options are affected. These details include:
 - What happens if you resign or are fired from your job?
 - What happens if your company is bought by another company?
 - What happens if you violate the terms of your employment agreement (for example, you fail to keep company secrets confidential)?
 - What are some conditions under which your stock options might be taken away from you, such as if you quit and go to work for a competitor?

In Chapter 5, we take an in-depth look at all of the details and associated legal language you'll likely come across in a stock option grant.

Exercising Your Stock Option (s)

When you decide to *exercise* a stock option, you make some type of formal declaration *as specified in your stock option grant* that you want to purchase a given number of shares at the strike price of those shares. For example, assume that you've been working at GreatPlaceToWork.com for over four years, and the stock option grant for 10,000 shares you received when you were hired is now completely vested. Your stock option grant may specify that you exercise stock options by contacting a specific financial institution with which your employer has set up a stock option execution program.



You likely will have some other supplemental material that guides you through all of the logistics of exercising stock options, such as paperwork you need to fill out and have on file and the telephone number to call to exercise options. So make sure that long before you even consider exercising your stock options, you have filled out all appropriate paperwork (either on



Traversing the terminology

Chances are, when you find yourself talking with people with stock options, you might hear the following:

“I have 20,000 stock options.”

“Yeah? Well, I have 50,000 stock options myself.”

“I only have 10,000 stock options now because I just started my job, but next year I should get another 10,000 stock options.”

Actually, people who phrase the details of their respective stock options this way are incorrectly describing what they have received from their respective companies. If you were to look at the wording in the typical stock option grant, you’ll probably find something like:

“GreatPlaceToWork.com (“The Company”) grants to Alan Simon (“The Grantee”) the Option to purchase Ten Thousand (10,000) shares of common stock of the Company at an option price of \$3 per share.”

In reality, the legal agreement that gives you the right to purchase (in this example) 10,000 shares is a *single* stock option. You don’t have 10,000 stock options; you *do* have one stock option to purchase 10,000 shares. I realize this might

sound like little more than an exercise in semantics, but consider the following situation.

You go to work for GreatPlaceToWork.com and you are granted an option to purchase 10,000 shares at the strike price of \$3 per share. Now, one year later when your annual performance review comes around, you are given a second stock option grant of 5,000 shares — this time at a strike price of \$4 per share. You don’t have 15,000 stock options; you *do* have two stock options (more precisely, two stock option grants) for a total of 15,000 shares of stock. Each of the two stock option grants is covered by a separate legal agreement. Usually, the majority of each of those legal agreements will be the same, except for the key details we mentioned earlier: strike price, number of shares, vesting schedule (the actual dates at which portions of the option grant become vested), and the actual expiration date of each respective grant.

In the real world, you’re more likely to say, “I have 15,000 stock options,” rather than the more wordy, “I have stock option grants for 15,000 shares.” As long as you understand that the latter is the correct terminology, and the former phrase is a kind of stock option slang, your word choice really doesn’t matter.

paper or online, however your employer lets you fill out the necessary forms) and are absolutely clear who to call or what procedures to follow when exercising time comes.

If you look at any stock option grant you receive (and we mention more about the legal language of stock options in Chapter 5), the portion that describes how you exercise stock options may say something like, “The Grantee may exercise part or all of the vested and exercisable option.” Translation: Only those shares that have vested can be exercised, no matter how much your company’s stock price has gone up and how badly you want to tap into those waiting-to-be-taken profits.



You will most likely hear someone say — or use the phrasing yourself — “I am exercising my stock options” (plural), regardless of whether shares from one or more stock option grants are involved. That’s why the heading for this section uses the phrase “stock option(s)” indicating that a decision to exercise could involve shares from a single stock option grant or more than one grant.

If you have received more than one stock option grant — say, one for 10,000 shares when you were hired, another six months later for 3,000 shares as part of an annual bonus, and a third grant six months later (one year after you were hired) for 5,000 shares as part of your annual performance review — then at some point in the future, you may exercise portions of all three option grants at the same time, subject to how many shares you have vested at that point. For example, Table 1-1 shows the details behind the three stock option grants we describe previously.

Table 1-1 **Your Three Stock Option Grants from
GreatPlaceToWork.com**

<i>Date of Grant Schedule</i>	<i># Shares</i>	<i>Strike Price</i>	<i>Vesting</i>
May 15, 2001 (25%/year)	10,000	\$3.00	4 years
December 15, 2001 (25%/year)	3,000	\$3.50	4 years
May 15, 2002 (25%/year)	5,000	\$4.00	4 years

Suppose that today’s date is January 5, 2004, your company’s stock price is \$10.00, and you want to (remember the wording from your stock option grant) “exercise part or all of the vested and exercisable option.” None of your three option grants has totally vested, so you are exercising part of each of three grants — the vested part of each. Half of your first grant has now vested, because today is more than two years but less than three years from the date of that grant. Likewise, half of your second grant has vested because today’s date is more than two years (by less than a month) from the date of that grant. Only $\frac{1}{4}$ of your third grant has vested, because today’s date is more than one year but less than two years from the date of that grant.

So your grant total: 5,000 vested and exercisable shares from your first grant, plus 1,500 vested and exercisable shares from your second grant, plus 1,250 vested and exercisable shares from your third grant, for a total of 7,750 shares.

You may want to exercise your options from all three grants at once, meaning that you will buy:

- ✓ 5,000 shares at \$3 per share (total: \$15,000)
- ✓ 1,500 shares at \$3.50 per share (total: \$5,250)
- ✓ 1,250 shares at \$4 per share (total: \$5,000)

For this example, we assume you immediately sell all of your shares at the market price of \$10.00, meaning that you will have paid \$25,250 (\$15,000 + \$5,250 + \$5,000) for 7,750 shares that you then sell for \$77,500, giving you a pre-tax profit of \$52,250.

Suppose, though, that you wanted to only exercise options on 3,000 shares and immediately sell those shares for the instant profit? You could do any of the following:

- ✓ Exercise an option on 3,000 of the 5,000 vested shares from your first stock option grant
- ✓ Exercise an option on 1,000 vested shares from each of your three grants
- ✓ Exercise an option on 2,000 vested shares from your first grant and 1,000 vested shares from your second grant

Or you could try another one of the thousands of options exercising combinations available to you. For example, you could exercise an option on 999 shares from the first option grant + 1001 shares from second option grant + 1000 shares from the third option grant, or 998 shares from the first option grant + 1000 shares from the second option grant + 1002 shares from the third option grant, and so on. Because the strike prices of each of the three grants are different, the amount you pay for the 3,000 shares of stock will be different in each one of the possible combinations available to you. In Chapter 6, we discuss exercising stock options in detail, including the many decisions you need to make when doing so.



You should remember two key points. First, you exercise stock options according to the official and legal procedures specified in your stock option grant(s). Second, you need to be very explicit about exactly how you want to exercise stock options when the time comes, including (when you have received more than one stock option grant) which grant(s) you are exercising at that time, and how many shares from each you are purchasing.

Understanding the Right Nature of Your Stock Options

A stock option grant gives you the right to purchase the number of shares specified in the grant, according to constraints such as the vesting schedule. However, a stock option grant doesn't create an obligation for you to purchase those shares, either at some specified time in the future or at all!

The timing by which you exercise a stock option, either a portion at a time as the option vests or in its entirety at some future date, is totally within your control. Much of the material in this book is intended to help you make an informed decision about when to exercise your stock options and under what circumstances. This book also helps you decide what to do with the shares you buy (sell them immediately or hold them until some future date) after you exercise an option and purchase shares.

However, *you* make those decisions, not your company's management, your stock broker, your financial advisor, or your company's Board of Directors. If you perform the level of analysis that you should and decide that you should exercise options on all of your vested shares tomorrow and sell those shares immediately, then you should do exactly that. On the other hand, if your analysis tells you that you should hold off on exercising options on any shares for at least three more years, then that's the course of action (or, in this case, inaction) you should take.



You may even find that you may never exercise any of your options, even though over the years you may have been granted options on 50,000 shares, 60,000 shares, or even more. In Chapter 2, we look at the financial downside of stock options, specifically what happens when your company's stock price drops below the strike price of your stock options and your options become worthless.

If stock options were an *obligation* to purchase shares at the strike price rather than a right — to do so, then someone could actually force you to purchase a large number of shares at a price that would force you to sell for an automatic loss. Or, at the very least, you could be forced to purchase shares of your company's stock for far more than you would pay by buying shares on the stock market. Fortunately, "stock options" is a self-describing term: You have the *option* to purchase stock, but nobody can actually force you to purchase shares if doing so would be against your own best financial interests.

Comparing Stock Options to Actual Shares of Stock

Say that two college friends — Steve and Kathy — go to work for a consulting company on the same day. Steve takes a job as a recruiter, while Kathy goes to work as a technology consultant. Assume that the company's current policy is that stock options are granted only to employees in certain job functions, such as consulting. However, employees in positions such as recruiting and other Human Resources job functions don't currently receive stock options.

Kathy receives options on 3,000 shares, priced at \$3 per share (the company's current stock price on the NASDAQ). Steve, however, doesn't receive stock options but still has good feelings about his new employer, so he scrapes together \$9,000 and buys 3,000 shares of stock on the same day that Kathy receives her stock option grant.

True or false: Kathy and Steve have the same equity (ownership) position in their employer: 3,000 shares of stock worth.

Answer: False! Steve *does* have an ownership position in the company because he actually purchased stock that he now owns. True, Steve's ownership position is very small — if the company has 50,000,000 shares of stock outstanding, then Steve's ownership position is only .006 percent. However, at that moment Steve still owns .006 percent more than Kathy does! Why? Because *stock options are not the same as stock*.

In every stock option agreement, you will find a clause called “No Shareholder Rights” (or a similar term) that explicitly states that until actual shares of stock have been issued as a result of part or all of a stock option being exercised, no rights or privileges of a shareholder exist for the option holder. So, for example, Steve can vote his 3,000 shares on all matters brought before the company's stockholders, such as electing members of the Board of Directors, or approving or disapproving motions such as anti-takeover measures. True, Steve's 3,000 shares aren't likely to have any significant weight by themselves when 49,997,000 other shares are out there, and most of them are concentrated in the hands of “The Big Guys” (see Chapter 4). But in the spirit of democracy, at least Steve has a legal right to vote on company matters along with every other stockholder.

Kathy, on the other hand, has no shareholder rights. She will have none until she either exercises her option to purchase shares, purchases shares of the company's stock through some other vehicle, such as an Employee Stock Purchase Plan (ESPP — see Chapter 11), or buys shares of the company's stock through the stock market, just as Steve did.



If Kathy exercises part or all of her stock option but immediately sells those shares for an instant profit, she does *not* have any shareholder rights. Technically, for a very brief instant between the time she receives the shares and the time they're sold, she does own shares of stock and has shareholder rights. But if her intention is to use her stock options as a vehicle for instant profit rather than to buy and retain shares of the company's stock in the future at a discount, then her shareholder rights evaporate as quickly as she can say "show me the money."

Granting Stock Options: Why Do Companies Do It?

Traditionally, workers in the United States and throughout most of the world have spent their careers under an umbrella of "management versus labor," or "us versus them." Until very recently, it was difficult to find many companies that encouraged its employees to "think and act like owners" — much less encourage its employees to actually *be* owners of the company. Employers use stock options for several purposes, including:

- ✓ Enabling employees to share in the company's growth and success as owners (or potential owners) in exchange for working hard
- ✓ Trying to build and retain a stable workforce in very competitive labor markets and during good economic times
- ✓ "Diverting" cash away from salaries and benefits toward other operational uses, and making up the difference to employees through potentially huge gains from their stock options

Hard work equals great rewards

Many companies issue stock options to their employees to encourage them to "go the extra mile" in their jobs — through extra long hours, extensive travel, and generally devoting a good portion of their lives to their company. The equation of "hard work equals great rewards" doesn't always hold true, but most employers agree that if a company's entire workforce works very hard — and very smart — that the chances for success are greatly increased.

But how can those employees be motivated to give so much of their lives to their jobs? In many cases, the answer is money. True, not everyone's primary workplace motivation is financial gain, but many people *will* make a lot of personal sacrifices for their job if they see the potential for high financial reward.

Companies could, of course, handle the reward portion of the equation through very high salaries and even higher bonuses. Some companies do operate on that model. However, other companies keep salaries and bonuses for their employees at ordinary levels and instead rely on stock options as the primary vehicle for granting great rewards. (We discuss more about overall compensation and how stock options figure into the picture in Chapter 9.)

Therefore, the “hard work equals great rewards” equation is actually a bit more complicated — something like “hard work equals company success equals great rewards.” Still sounds about the same, right? Not quite!



A company that uses high salaries and bonuses as its means of rewarding employees has direct control over the reward side of the equation. If the company does well, then the profits can be distributed according to a preset schedule of salary increases and bonuses. Not so with a stock option-based model, however. Why? Because increases in the value of employee stock options is tied to increases in the company’s stock price, and the company does *not* have direct control and influence over its stock price. Even if the company is doing very well and is very profitable, its stock price could still be depressed if the stock market as a whole is in a slump, or for other reasons that we discuss in Chapter 10. So with stock options, the equation is more like “hard work equals company success equals great rewards, but only if the investing public really likes the company’s stock.” That warning aside, the motivation for issuing stock options is still “to encourage employees to work hard to make the company successful.”

Building (or trying to build) a stable workforce

The days of people going to work for a company right out of college and staying there until retirement are just about gone. Every so often, I run into someone who has been with the same employer for 15 or 20 years, but for the most part, people jump around from company to company these days with increasing frequency.

The more a company’s workforce changes and the less stable its workforce is, the less likely it is to gain and hold business momentum in whatever it does – build computer or communications hardware products, provide consulting services to others, manufacture and package toys, or whatever. But how can a company encourage you that the grass really isn’t greener on the other side and that staying with the company can have long-term benefits not only for the company but for you as well?

One way to encourage employee retention is through the use of stock options. The multi-year vesting schedule associated with most stock option

grants (discussed earlier in this chapter) means that if you leave to go to a new job, any gains from unvested shares will be lost. Therefore, companies want you to consider staying put so that you can gain access to more money as your shares vest.

By periodically issuing new stock option grants to you, your company can always ensure that some targeted number of unvested shares is “on the table” and would be lost if you resign and take a new job. For example, when all of your initial shares have vested, you have no unvested shares left and (the theory goes) no incentive to keep working for the company. But if the company keeps granting you new options (say once a year as part of your annual review), you will never get to the point where all shares on all option grants have vested. Therefore, you would always be “leaving money on the table” if you were to leave (assuming, of course, that the company’s stock price is higher than the strike price of unvested shares you’re holding). In Chapter 2, we discuss the “mixed blessing” of stock options as golden handcuffs — locking you into a job you don’t really like because if you leave, you’ll be leaving behind lots and lots of money.

“Diverting” cash from salaries to other uses

The Great Internet Boom of the Late 1990s caused many long-time technology industry practitioners and observers to gasp in awe at the billions of dollars in investment capital that was, basically, thrown at unproven startup companies. Every day you would read stories about some brand new “e-consulting” company receiving \$50 million in venture capital, or some wireless communications startup turning away investors because it had already landed the \$500 million it was looking for.

However, the crash of so many Internet-related companies during 2000 brought a bit of reality back to the world of startup companies, and turned people’s attention back to a fundamental principle of starting a business: conserving cash! Now that dozens of dot-com Super Bowl ads and other such nonsense are behind us, we find struggling companies doing everything in their power to conserve their dwindling supplies of cash in order to become profitable.

So what does all this have to do with stock options? During a company’s early days, management would, ideally, rather use limited cash resources for operations, marketing, and similar key business needs, rather than for salaries and other forms of cash compensation (such as bonuses). By creating compensation packages that shave a little bit — or a lot — off of the cash portion of the package in exchange for generous grants of stock options, the company can divert cash toward operational uses. In theory, better-funded operations should lead to a greater chance of business success and a shorter time

to profitability, which in turn would lead to higher and higher company stock prices. And, as the company's stock price rises, those employees who accepted less cash in their compensation packages would be rewarded through gains in their stock option holdings.

(Note the close relationship between wanting to divert cash and rewarding employees and building a stable workforce. As you can probably tell, these reasons are all fairly intertwined.)



Some business leaders are very critical of the cash diversion approach to stock options, however. For example, Warren Buffett, one of the most respected investors for many years (and also one of the wealthiest people in the world), was cited in a 1999 *US News & World Report* article as being critical of stock option-issuing companies for being able to “hide” compensation expenses from their financial statements and “inflate” their earnings, leaving a ticking time bomb for investors when large numbers of stock options are exercised. The exact phrase used in reporter James Lardner's article: “fiscal chicanery — a claim against future corporate earnings that isn't reflected on the books.” Now that's a strong statement!

So be warned that even when the fundamental premise of stock options works in favor of a company's employees as the company's stock price rises, macro-financial forces need to be considered in gauging the company's *true* financial picture.

Comparing the Two Main Types of Stock Options

So far, everything we discuss in this chapter has been relatively straightforward, as you might expect (and hope for) from an introductory chapter. However, one introductory-level aspect of stock options is fairly complex: the two different types of stock options.

I introduce the two types in this chapter so that you can become familiar with the terminology and the distinction between these two. Later in the book, particular Chapters 13 and 14 when we discuss taxation issues, we go into more detail about these two types. The two stock option types are:

- ✓ Incentive stock options (ISOs)
- ✓ Nonqualified stock options (NQSOs)

Incentive stock options are governed by a very tight set of Internal Revenue Code (IRC) restrictions that specify:

- ✔ Who is permitted to receive ISOs (answer: only employees)
- ✔ A statutory expiration date for ISOs (no more than ten years after the date of the option grant)
- ✔ What rules must be stated in the company’s ISO documents
- ✔ How ISOs are taxed (answer: very complicated; we tackle that one in Chapter 14!)

Nonqualified stock options, in contrast, are defined as “stock option plans that for some reason don’t satisfy the legal requirements to qualify as an ISO.” NQSO rules and guidelines specify:

- ✔ Who can receive NQSOs (answer: not only employees, but also other people such as members of the Board of Directors)
- ✔ The tax implications of NQSOs (answer: different from ISOs, but just as complicated! Again, stay tuned for Chapters 12 and 13 rather than worry about all of those details now.)

The most important point to remember about ISOs and NQSOs is that the right-off-the-bat basics of both types of stock options are the same. Both types of stock options grant you the right to purchase shares of stock at some date in the future at a contractually guaranteed price, regardless of how much higher the market price of the stock is than the strike price. The calculations in this chapter’s examples and in many of the examples throughout subsequent chapters are unaffected by whether the options are incentive, nonqualified, or a mixture of both types. It’s only when we get to the “mechanics” — the nuts and bolts of exercising stock options, how long you hold the shares of stock you acquire, and how all of these various scenarios are taxed — that distinctions between ISOs and NQSOs become significant.



Beware! Some companies will give you little, if any, information about what type(s) of stock options you’re being granted! Your prospective employer may provide only the most basic information about your stock options in conversation: the number of shares, the strike price, and the vesting schedule. Nothing more, though, until the stack of papers (specifically, the employment agreement and stock option agreement) are handed to you with a “sign these” command. The antidote: going into job offer discussions fully informed and knowing what questions to ask.

Even though your employment offer letter will mention whether you're being granted ISOs or NQSOs and the stock option agreement will use about 15 pages to describe all of the restrictions that are being placed on your stock option grant, just *try* and get information from your employer about how your options will be taxed or other important information that is dictated by the type of option grant you receive. In most cases, you need to figure out all of this information on your own; so you're doing the right thing by starting now.