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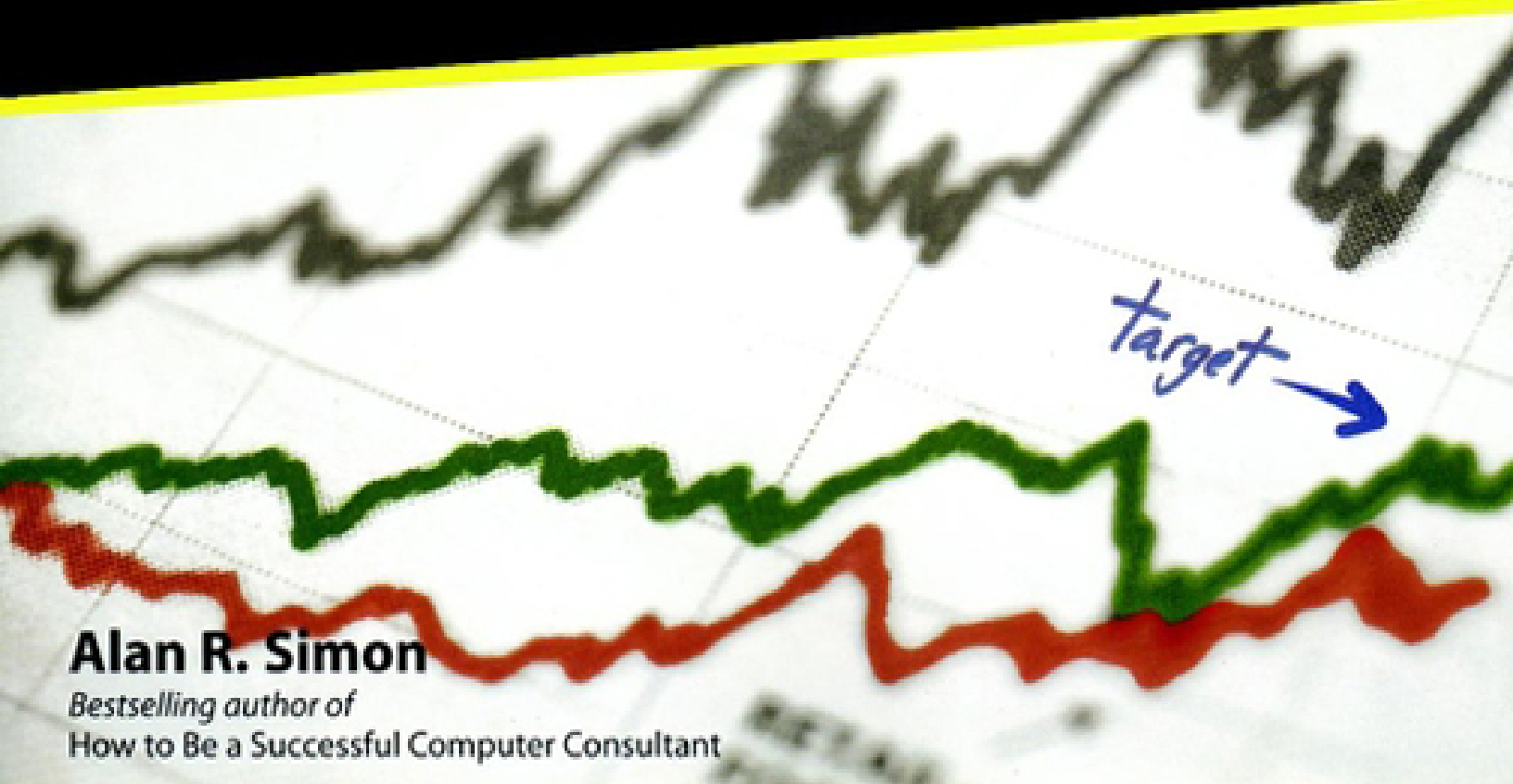


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# Stock Options

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# ***Stock Options For Dummies®***

**by Alan Simon**



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# About the Author

**Alan Simon** is a computer consultant, author of 26 books (including *Data Warehousing For Dummies*), and farmer. He has held a number of executive positions in technology consulting firms, and has been a computer professional since the late 1970's. His extensive experiences with his own stock options — sometimes painful experiences — have provided him with an objective, no-hype perspective of stock options that he imparts in this book.

Alan lives on a farm in Northeastern Pennsylvania.

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# Introduction

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Even though an estimated 12 million U.S. employees have stock options as a key component of their respective compensation packages, many of those people understand only the most basic aspects of their stock options.

This lack of stock option knowledge, however, is understandable when you realize how most companies handle the granting of stock options to their employees. When a job offer is extended, a representative from the HR (Human Resources) department will usually follow up the salary offer with a bland, imprecise statement, something along the lines of “oh, yeah, you also get 5,000 stock options.”

But no mention of the vesting schedule for those shares, no mention of how the strike price for those 5,000 shares will be set, and usually no mention of what kind of stock option grant you will receive — an incentive stock option (ISO) grant or a nonqualified stock option (NQSO) grant, each with different tax consequences. (If this book is your first exposure to the world of stock options, don’t worry about the terminology in the preceding paragraph: I cover those terms along with other stock option basics in Chapter 1.)

# Why I Wrote This Book: The Lessons of 1999 and 2000

I wrote *Stock Options For Dummies* for several reasons:

- ✓ To demystify the complex terminology, rules, and tax consequences of stock options
- ✓ To provide readers with a realistic picture of what to expect from their respective stock options
- ✓ To help readers get beyond the “you’ll certainly get rich!” pitch from less-than-candid prospective employers, and to evaluate stock options as part of an overall compensation picture

You can look at the years 1999 and 2000 to see stock options in a realistic light. For most of the 1990s, having a stock option package was like having a license to print money — very often, lots of money. The stock option phenomenon reached its crest in 1999 as technology stocks and Internet-related stocks in particular zoomed beyond any realistic measures of the underlying values of the companies themselves. The “first day pop” (the day a company went public) became sort of a contest by 1999: Could the company’s stock price go up 300 percent the first trading day? 400 percent? Even more?

But the boom was fun while it lasted, and many employees of those companies became wealthy —

perhaps even extremely wealthy — primarily on the soaring value of their stock options. The primary concern of many option holders during the late 1990s was how to minimize taxes on the spectacular gains on those options. But the spectacular gains were never in question: They would happen, and quickly!

Alas, when technology stocks — and, again, Internet stocks in particular — crashed during 2000, many of those stock option millionaires or billionaires watched as their wealth shrank or even vanished. In some cases, the plummeting in the value of any given individual's stock options couldn't be prevented, given the rules of stock options with regard to when an option holder is — and isn't — to cash in on paper gains. In other cases, though, the “now you have it, now you don't” magic trick that caused hundreds of billions of dollars in stock option paper wealth to vanish could have been prevented, at least in part.

How? If a stock option holder had followed some of the basic principles of investing and managing a portfolio, then that person may have realized that the company's stock had gone way too high, way too fast. Therefore, that person would have “taken some of the money off the table” by cashing in some of those shares of stock and redeploying the proceeds into other investments. Alas, for so many option holders (just like many technology stock investors in general), greed and unrealistic expectations became the order of the day, and the price

was eventually and painfully paid when stock prices went into a tailspin.

But did the stock market of 2000 signal the end of stock options as a key component of employees' compensation packages? Reading some of the press stories near the end of the year, you might think so. "Employees leave behind worthless stock options, seek higher salaries" was the prevalent theme of so many news stories during the fall of 2000, so you might be tempted to think of stock options as little more than a passing fad whose best days were in the past.

I disagree. The stock option genie is out of the bottle, and even those whose dreams of stock option-fueled wealth and early retirement didn't pan out have had a taste of aspiring to more than just a salary from their respective jobs. I believe that stock options are here to stay, but many people will (hopefully) be much more realistic and much smarter about their options packages in the days ahead.

And that's where *Stock Options For Dummies* comes in: to provide that "big picture view" of stock options that takes into consideration not only the basics such as vesting schedules and tax laws, but also the following:

- ✓ How to read your stock option agreement paperwork and look for traps

- ✓ How to figure out if the company making you the job offer with the stock options is a “real” company with solid prospects or just a fly-by-night, get-rich-quick scheme for venture capitalists and its founders — but not for you and your coworkers
- ✓ Understanding the consequences to your stock options of leaving your job, having the company sold, or some other significant change
- ✓ Where to find up-to-date information, group discussion, and assistance on the Internet about critical stock options issues

## Who Needs to Read This Book?

*Stock Options For Dummies* is intended for anyone who has a current stock option package, whether it’s doing well or not; anyone who is considering a job with a stock option package and needs to watch out for traps, make sure he’s being treated fairly, understand what he’s getting into; and finally, anyone who wants a no-hype, realistic discussion about stock options: the good, the bad, and the ugly.

## How to Use This Book

*Stock Options For Dummies* is written in easily understood language from cover to cover, with liberal



use of examples. Some of the topics covered are very basic — the stock options basics covered in Chapter 1, for example — while other material, such as the chapters on stock option taxation, is more advanced.

Some readers for whom stock options is a brand new topic (that is, readers who have never had a job with stock options) would be best served by first reading the book cover to cover, and then using the book as a reference for specific topics that come up in the future (for example, finding out an employer is being acquired by another company, and wanting to figure out what will happen to existing stock options).

Other readers with a bit more exposure may want to selectively read certain chapters, and either skip or skim others. I recommend at least skimming every chapter, even if you currently have stock options or have held options in the past and understand the basics pretty well. Most chapters contain not only the basic information about that chapter's subject but also anecdotes and "gotchas" that you may not have come across — yet!

Many of the chapters have a number of cross-references to other chapters — more than you would find in a typical . . . *For Dummies* book. The reason is that so many stock options topics are interrelated, and I wanted to be as thorough as possible within any given chapter to point you to another chapter (or two or three chapters) where you will find related information about a specific example or anecdote.

# How This Book Is Organized

*Stock Options For Dummies* is organized into six parts. The chapters within each part cover specific topics in detail, as described in the following sections.

# Part I: The Fundamentals of Stock Options

The chapters in Part I cover the fundamentals and are particularly appropriate for readers who are newcomers to the world of stock options. (But I recommend even experienced option holders skim the chapters to pick up a tidbit or two with which they aren't familiar or haven't yet come across.)

Chapter 1 covers the stock option basics that you must understand to make informed decisions about accepting a job and an accompanying stock options packages. Vesting, strike prices, how you might make money on your options: It's all in there. Chapter 2 takes an honest, no-hype, no-holds-barred look at "the good, the bad, and the ugly" sides of stock options. Stock options aren't a license to print money, nor are they some type of evil incarnate tool. Stock options are simply a financial instrument that can greatly benefit those who own them, but by no means are those benefits guaranteed.

Building on the basics in the first two chapters, Chapter 3 helps you develop your philosophy about stock options. Should you look at stock options as an entrepreneur might, or are stock options simply a bonus that supplements your salary? You need to match your philosophy to the right stock option situation: the type of company, the type of stock option package you receive, and the amount of risk you're willing to accept.

Finally, Chapter 4 takes a look at the big guys and their stock options, as well as other equity-based instruments they usually have at their disposal. Maybe you're a big guy yourself, or hope to be one day. Make sure that you're being treated fairly, on par with the other big guys at your company, by being as informed as possible.

# **Part II: Details, Details: What You Must Know About Your Stock Options**

The Part II chapters add nuts and bolts onto the basics and philosophical aspects of Part I. Chapter 5 helps you understand the language in your stock option agreement — a legally binding agreement — and where to watch out for hidden traps. Chapter 6 steps you through the process of exercising your stock options, and what happens if you immediately sell the shares you acquire from the exercise versus what happens if you hold on to those shares.

Chapter 7 discusses the differences between stock options in pre-IPO companies and those companies that have already gone public, and what happens to your stock options along the way. Chapter 8 discusses two key restrictions — blackout periods and lockup periods — that govern when you can and can't exercise options and sell shares. Finally, Chapter 9 take you into the Internet and a guided tour of online resources where you can find the latest and greatest about stock options, applicable tax laws, and related material.

## **Part III: Money!**

The two chapters in Part III help you gain a realistic sense of the value of your stock options on their own and in the context of your overall portfolio. Chapter 10 discusses stock option valuation, including different approaches of varying complexity you can use, while Chapter 11 helps you figure out how to balance your stock options and other investments you have in your employer (such as actual shares of stock you hold) with your other investments and your personal and family needs.