

How Stock Options Work

Employee stock-option programs are typically authorized by a company's board of directors (and have historically been approved by the shareholders) and give the company discretion to award options to employees equal to a certain percentage of the company's shares outstanding.

Options give employees the right to buy a certain number of their company's shares at a fixed price for a certain period of time, usually 10 years.

That price, usually the market price of the stock on the date the options are granted, is called the "strike price."

Options usually begin vesting after one year and vest fully after four years. If an employee leaves the company before his or her options vest, they are canceled.

Once an option is vested, the employee can then "exercise" it--that is, purchase from the company the allotted number of shares at the strike price--and then either hold the stock or sell it on the open market.

The difference between the strike price and the market price of the shares at the time the option is exercised is the employee's gain in the value of the shares.

When the option's strike price exceeds the market price of the stock, the option is technically worthless, or "under water."

When the market price of the stock exceeds the strike price of the vested option, the option has value, or is "in the money."

When an employee exercises an option, the company must issue a new share of stock that can be publicly traded. While the employee pays the company the strike price for that share, the company's market capitalization grows by the market price of that share.

Having more shares outstanding dilutes (or reduces) earnings per share--and thus the value of shares held by investors who already own the stock.

To forestall dilution, one of two things must happen: earnings must increase commensurate with the increase in outstanding shares, or the company must repurchase shares on the open market to reduce the number of outstanding shares.