

J P MORGAN CHASE & CO

FORM 10-K (Annual Report)

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Note 9 – Employee stock-based incentives

Employee stock-based awards

In 2009, 2008, and 2007, JPMorgan Chase granted long-term stock-based awards to certain key employees under the 2005 Long-Term Incentive Plan (the “2005 Plan”). The 2005 Plan, plus prior Firm plans and plans assumed as the result of acquisitions, constitute the Firm’s stock-based incentive plans (collectively, “LTI Plan”). The 2005 Plan became effective on May 17, 2005, and was amended in May 2008. Under the terms of the amended 2005 plan, as of December 31, 2009, 199 million shares of common stock are available for issuance through May 2013. The amended 2005 Plan is the only active plan under which the Firm is currently granting stock-based incentive awards.

Restricted stock units (“RSUs”) are awarded at no cost to the recipient upon their grant. RSUs are generally granted annually and generally vest at a rate of 50% after two years and 50% after three years and convert into shares of common stock at the vesting date. In addition, RSUs typically include full-career eligibility provisions, which allow employees to continue to vest upon voluntary termination, subject to post-employment and other restrictions based on age or service-related requirements. All of these awards are subject to forfeiture until the vesting date. An RSU entitles the recipient to receive cash payments equivalent to any dividends paid on the underlying common stock during the period the RSU is outstanding and, as such, are considered participating securities as discussed in Note 25 on page 224 of this Annual Report.

Under the LTI Plan, stock options and stock appreciation rights (“SARs”) have been granted with an exercise price equal to the fair value of JPMorgan Chase’s common stock on the grant date. The Firm typically awards SARs to certain key employees once per year, and it also periodically grants discretionary stock-based incentive awards to individual employees, primarily in the form of both employee stock options and SARs. The 2009, 2008 and 2007 grants of SARs to key employees vest ratably over 5 years (i.e., 20% per year) and do not include any full-career eligibility provisions. These awards generally expire 10 years after the grant date.

The Firm separately recognizes compensation expense for each tranche of each award as if it were a separate award with its own vesting date. Generally, for each tranche granted, compensation expense is recognized on a straight-line basis from the grant date until the vesting date of the respective tranche, provided that the employees will not become full-career eligible during the vesting period. For awards with full-career eligibility provisions, the Firm accrues the estimated value of awards expected to be awarded to employees who will be retirement-eligible as of the grant date without giving consideration to the impact of post-employment restrictions. For each tranche granted to employees who will become full-career eligible during the vesting period, compensation expense is recognized on a straight-line basis from the grant date until the earlier of the employee’s full-career eligibility date or the vesting date of the respective tranche.

The Firm’s policy for issuing shares upon settlement of employee stock-based incentive awards is to issue either new shares of common stock or treasury shares. During 2009, 2008 and 2007, the Firm settled all of its employee stock-based awards by issuing treasury shares.

In January 2008, the Firm awarded to its Chairman and Chief Executive Officer up to 2 million SARs. The terms of this award are distinct from, and more restrictive than, other equity grants regularly awarded by the Firm. The SARs, which have a 10-year term, will become exercisable no earlier than January 22, 2013, and have an exercise price of \$39.83. The number of SARs that will become exercisable (ranging from none to the full 2 million) and their exercise date or dates may be determined by the Board of Directors based on an annual assessment of the performance of both the CEO and JPMorgan Chase. The Firm recognizes this award ratably over an assumed five-year service period, subject to a requirement to recognize changes in the fair value of the award through the grant date. The Firm recognized \$9 million and \$1 million in compensation expense in 2009 and 2008, respectively, for this award.

In connection with the Bear Stearns merger, 46 million Bear Stearns employee stock awards, principally RSUs, capital appreciation plan units and stock options, were exchanged for equivalent JPMorgan Chase awards using the merger exchange ratio of 0.21753. The fair value of these employee stock awards was included in the Bear Stearns purchase price, since substantially all of the awards were fully vested immediately after the merger date under provisions that provided for accelerated vesting upon a change of control of Bear Stearns. However, Bear Stearns vested employee stock options had no impact on the purchase price; since the employee stock options were significantly out of the money at the merger date, the fair value of these awards was equal to zero upon their conversion into JPMorgan Chase options.

The Firm also exchanged 6 million shares of its common stock for 27 million shares of Bear Stearns common stock held in an irrevocable grantor trust (the “RSU Trust”), using the merger exchange ratio of 0.21753. The RSU Trust was established to hold common stock underlying awards granted to selected employees and key executives under certain Bear Stearns employee stock plans. The RSU Trust was consolidated on JPMorgan Chase’s Consolidated Balance Sheets as of June 30, 2008, and the shares held in the RSU Trust were recorded in “Shares held in RSU Trust,” which reduced stockholders’ equity, similar to the treatment for treasury stock. A related obligation to issue stock under these employee stock plans is reported in capital surplus. The issuance of shares held in the RSU Trust to employees has no effect on the Firm’s total stockholders’ equity, net income or earnings per share. Shares held in the RSU Trust were distributed in 2008 and 2009, with a majority of the shares in the RSU Trust distributed through December 2009. There were 2 million shares in the RSU Trust as of December 31, 2009. The remaining shares are expected to be distributed over the next three years.

RSU activity

Compensation expense for RSUs is measured based on the number of shares granted multiplied by the stock price at the grant date and is recognized in income as previously described. The following table summarizes JPMorgan Chase's RSU activity for 2009.

Year ended December 31, 2009 (in thousands, except weighted average data)	Number of shares	Weighted-average grant date fair value
Outstanding, January 1	148,044	\$ 42.53
Granted	131,145	19.68
Vested	(49,822)	43.34
Forfeited	(8,102)	29.58
Outstanding, December 31	221,265	\$ 29.32

The total fair value of shares that vested during the years ended December 31, 2009, 2008 and 2007, was \$1.3 billion, \$1.6 billion and \$1.5 billion, respectively.

Employee stock option and SARs activity

Compensation expense, which is measured at the grant date as the fair value of employee stock options and SARs, is recognized in net income as described above.

The following table summarizes JPMorgan Chase's employee stock option and SARs activity for the year ended December 31, 2009, including awards granted to key employees and awards granted in prior years under broad-based plans.

Year ended December 31, 2009 (in thousands, except weighted-average data)	Number of options/SARs	Weighted-average exercise price	Weighted-average remaining contractual life (in years)	Aggregate intrinsic value
Outstanding, January 1	283,369	\$ 47.21		
Granted	24,821	20.83		
Exercised	(17,406)	30.81		
Forfeited	(1,913)	39.85		
Canceled	(22,303)	47.88		
Outstanding, December 31	266,568	\$ 45.83	3.4	\$1,311,897
Exercisable, December 31	214,443	48.94	2.2	765,276

The weighted-average grant date per share fair value of stock options and SARs granted during the years ended December 31, 2009, 2008 and 2007, was \$8.24, \$10.36 and \$13.38, respectively. The total intrinsic value of options exercised during the years ended December 31, 2009, 2008 and 2007, was \$154 million, \$391 million and \$937 million, respectively.

Compensation expense

The Firm recognized noncash compensation expense related to its various employee stock-based incentive awards of \$3.4 billion, \$2.6 billion and \$2.0 billion for the years ended December 31, 2009, 2008 and 2007, respectively, in its Consolidated Statements of Income. These amounts included an accrual for the estimated cost of stock awards to be granted to full-career eligible employees of \$845 million, \$409 million and \$500 million for the years ended December 31, 2009, 2008 and 2007, respectively. At December 31, 2009, approximately \$1.6 billion (pretax) of compensation cost related to unvested awards had not yet been charged to net income. That cost is expected to be amortized into compensation expense over a weighted-average period of 1.2 years. The Firm does not capitalize any compensation cost related to share-based compensation awards to employees.

Cash flows and tax benefits

Income tax benefits related to stock-based incentive arrangements recognized in the Firm's Consolidated Statements of Income for the years ended December 31, 2009, 2008 and 2007, were \$1.3 billion, \$1.1 billion and \$810 million, respectively.

The following table sets forth the cash received from the exercise of stock options under all stock-based incentive arrangements, and the actual income tax benefit realized related to tax deductions from the exercise of the stock options.

Year ended December 31, (in millions)	2009	2008	2007
Cash received for options exercised	\$437	\$1,026	\$2,023
Tax benefit realized	11	72	238

In June 2007, the FASB ratified guidance which requires that realized tax benefits from dividends or dividend equivalents paid on equity-classified share-based payment awards that are charged to retained earnings be recorded as an increase to additional paid-in capital and included in the pool of excess tax benefits available to absorb tax deficiencies on share-based payment awards. Prior to the issuance of this guidance, the Firm did not include these tax benefits as part of this pool of excess tax benefits. The Firm adopted this guidance on January 1, 2008, and it did not have an impact on the Firm's Consolidated Balance Sheets or results of operations.

The following table presents the assumptions used to value employee stock options and SARs granted during the years ended December 31, 2009, 2008 and 2007, under the Black-Scholes valuation model.

Valuation assumptions			
Year ended December 31,	2009	2008	2007
Weighted-average annualized valuation assumptions			
Risk-free interest rate	2.33%	3.90%	4.78%
Expected dividend yield ^(a)	3.40	3.57	3.18
Expected common stock price volatility	56	34	33
Expected life (in years)	6.6	6.8	6.8

(a) In 2009, the expected dividend yield was determined using historical dividend yields.

The expected volatility assumption is derived from the implied volatility of JPMorgan Chase's publicly traded stock options. The expected life assumption is an estimate of the length of time that an employee might hold an option or SAR before it is exercised or canceled, and the assumption is based on the Firm's historic experience.

Consent of independent registered public accounting firm

We hereby consent to the incorporation by reference in the Registration Statements on:

Form S-3 Nos: 333-146731, 333-146220, 333-155535 and 333-151397; and

Form S-8 Nos: 333-145108, 333-142109, 333-125827, 333-112967, 333-64476, 333-47350, 333-31666, 333-31634, 333-73119, 333-150208 and 333-158325

of JPMorgan Chase & Co. or its affiliates of our report dated February 24, 2010 relating to the financial statements and the effectiveness of internal control over financial reporting, which appears in this Annual Report on Form 10-K.

/s/ PricewaterhouseCoopers LLP
New York, New York
February 24, 2010