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Anticipating Next Year's Option Awards: A Thought Piece About Capturing Option Value

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Difficulty in measuring the value of employee stock options, and inequality between option expense and the perceived value to employees, underlie the long public debate about equity compensation accounting.

Two recent developments are linked in a way that should cause financial and human resources executives to think – creatively and outside the box – about their option programs. The developments open up an opportunity for companies to be straightforward, objective and transparent about the cost of options and to offer options that have the same perceived value to employees as the expense required to be booked.

Zions Bancorporation's ESOARS

On January 25, 2007, the SEC's Chief Accountant wrote to Zions Bancorporation about Zions' "ESOARS" product. ESOARS (an acronym for "Employee Stock Option Appreciation Rights Securities") are derivative securities designed to provide a market basis for estimating option fair value. The idea is that the value derived from purchases and sales of the ESOARS would be used as the basis for recording stock option expense under FAS 123R, rather than a value derived from a Black-Scholes or other formulaic approach.

The Chief Accountant's primary concern with market-based methodologies using derivative securities to estimate option fair value is whether the prices paid in particular market transactions genuinely indicate fair value. First, the derivative security must be designed so that it properly reflects the value of the underlying referenced employee stock options. Second, the trading market for the derivative security has to reflect arm's-length free market principles. A limited number of bidders, limitations on information available to bidders, limited liquidity in the secondary market or other factors might distort the prices paid and therefore cause them not to reflect a fair value for the underlying referenced options.

The SEC's letter to Zions was favorable, but noncommittal. The letter states that "the SEC staff concurs with your view that the ESOARS instrument is sufficiently designed to be used as a market-based approach to valuing employee share-based payment awards under Statement 123R." However, the letter also notes that "two factors in your first auction (the two minute rule mechanism, and technological delays) may have contributed to a market clearing price for ESOARS that may have not been representative of the fair value of the underlying employee share-based payment awards," and it concludes that "the SEC staff recommends, therefore, that each ESOARS auction be analyzed to determine whether it results in an appropriate market pricing mechanism."

Shortly after the letter was released, the general counsel of the Council of Institutional Investors, a shareowner-rights organization, objected to the SEC's letter to Zions and expressed a policy concern about the effect of ESOARS in connection with the very hot topic of excessive executive pay. The CII letter stated that "it appears that Zions' experience to-date is that the ESOARS produce a value far below that produced by the well known, and Securities and Exchange Commission staff approved, modified Black-Scholes-Merton model. It has been reported that Zions' vice president has boasted that 'companies using Zions' auction system can reasonably expect *to add back as much as half of their options expenses to pretax profits*.'" As the options actually issued to employees are unchanged, the main motivation for a company to conduct an ESOARS auction appears to be to obtain a *lower* expense for the options granted.

The SEC's response to CII elaborates on the reservation included in its prior letter to Zions: "the propriety of using a market instrument for financial reporting purposes is dependent upon the design, implementation, and marketing of the instrument. A company and its auditor will need to carefully analyze the results of each sale transaction, ensuring that a market pricing mechanism and credible information plan are present (both of which were discussed in a September 2005 memorandum issued by our Office of Economic Analysis). The factors that would need to be considered to ensure that the auction process results in the sale of market instruments at what can truly be deemed market prices include, but are not limited to, the size of the offering relative to market demand, the number and characteristics of participants (bidders), the functionality of the technology, and purchaser perceptions concerning costs of holding, hedging, or trading the instrument." Companies will have to carefully consider how to proceed with ESOARS-like approaches in light of this guidance.

Google's Transferable Stock Option Program

In February, Google filed a prospectus supplement with the SEC concerning amendments to its stock option program to make stock options granted to employees transferable. The amendments were rolled out on a test basis for twenty employees initially, and were expected to be introduced company-wide in April.

Google's employee stock options previously provided the normal benefit to employees, based on appreciation in the Google stock price. As explained on Google's blog, "with the new [transferable stock options], employees will have an additional alternative: they can transfer (sell) their options to a financial institution through a competitive bidding process. In addition to increasing the value of every option employees receive, the TSO program makes the value of their options much more tangible. In the past, employees typically valued Google stock options based simply on the difference between their option exercise price and the current market stock price (called the intrinsic value). Since Google grants options with exercise prices that are at, or above, the market price of Google stock, many employees do not value options on the day they are granted. By showing employees what financial institutions are willing to pay for their options, it is made clear that the value of their options is greater than just the intrinsic value."

Google's amended options have economic characteristics that are a hybrid of options and restricted stock. That is, transferable employee stock options have the leveraged upside return potential of stock options, but also have value to the employees if the underlying stock price stays flat or declines, as is the case with restricted stock. The hybrid payout profile fits nicely, from Google's perspective, with the general trend in compensation design away from programs that rely exclusively on stock options and towards programs that use a combination of options and restricted stock. This trend was of course accelerated by the loss of prior accounting benefits for options under FAS 123R, but also reflects a determination that combining employee stock options and restricted stock is a better way to retain, incentivize and compensate executives. Among other benefits, it mitigates the issues that arise when employee stock options are deeply underwater and are viewed as having virtually no value, while the employer continues to book the expense and the option overhang factors into investor perceptions of the stock.

The IRS recently issued a private ruling that appears to relate to the Google program. The ruling is based largely on the fact that the options are not transferable until vested. The ruling concludes, in effect, that since the options are not immediately transferable the options are not taxable to employees at the time of grant. Rather, the options are taxable to an employee when he or she sells or exercises the option, consistent with the tax treatment of non-transferable employee stock options. Although the tax result is not surprising, the vesting provision is important to note. Without delayed vesting, the tax rules might be interpreted to require that employees recognize taxable income in respect of the option immediately at the time of grant. Furthermore, immediate vesting would eliminate most of the incentive and retention value of transferable options, because employees could sell them upon grant, which they would of course be motivated to do in order to pay the tax.

The Link Between ESOARS and TSOs

In considering the Zions and Google developments together, the obvious question is whether companies can use the value derived from transferability of employee stock options to measure compensation expense for accounting purposes. Such a system should provide a correspondence between the value expensed for the options and the value of the options to the employees, a correspondence that is missing under current practice and rules. The principal gap is that FAS 123R requires a fair value at the time of grant, and Google's transferable options are not transferable until they vest.

The design feature that would link these ideas is, perhaps, also obvious. Rather than relying on the prices at which employees sell transferable stock options to establish option fair value, there must be sales of the options at the time the options are granted. The solution is to have the options issued by a financial institution, rather than the employer, and sold by the financial institution to the employer. Here is how it could work.

E, the employer, plans to grant one million employee stock options to its employees. Traditionally, E has granted stock options that have a term of up to ten years and an exercise price equal to the closing price of E's stock on the grant date, and vest over four years. E's options traditionally terminated 90 days after termination of employment for any reason, other than for cause, in which case they terminated immediately. E could replicate these terms, as follows:

- F, the financial institution, would sell to E ten-year options to purchase from F one million shares of E stock with an exercise price equal to the closing price of E's stock on the sale date (we refer to these as the "FIOs," or F-issued options).

- E would immediately distribute the FIOs to E's employees.

- If an employee terminates employment with E within four years from the grant date or is terminated for cause, the employee would be required to return the FIOs (or a portion thereof based on the vesting schedule) to E.

- The FIOs would be transferable in the same manner as the Google options. That is, after the FIOs vest an employee could transfer the FIOs to F or a different financial institution. Just as in the Google program, a competitive bidding process will ensure that employees get a fair price for FIOs offered for sale.

- FIOs could also be exercised for stock, as with traditional employee stock options, but employees would not be expected to exercise because the sale value will almost always be greater than the spread on exercise.

- Upon termination of employment other than for cause, employees could be required to sell their vested FIOs within 90 days (which reflects current practices), or could be permitted to keep their FIOs (based on the perspective that they had been fully earned). If the former design were to be adopted, after the expiration of the 90-day period any FIOs still held by an employee would revert to E. Also, since FIOs would have value even if underwater, employees who terminate employment at a time that they hold vested FIOs and who are not permitted to retain the FIOs until expiration would be expected to sell all of their FIOs within the 90-day period.

- FIOs forfeited by an employee to E as a result of termination prior to vesting or for cause would be owned by E. E could hold the FIOs for their full ten years to get the full benefit of the ten-year option that it purchased from F. Alternatively, E could sell FIOs in the same competitive bidding process available to employees at any time prior to their expiration.

The foregoing is a basic outline of a transferable option program that seems to produce a market basis for determining the fair value of the options – namely, the price paid by E to F for the FIOs. Why would E want to spend cash to purchase options to be granted to employees, when E can write those options itself without having to use any cash? There are at least three reasons:

- First, to provide greater certainty and transparency about the cost of E's stock option program and to align the reported expense with the benefit delivered to employees.

- Second, like many employers, E may already be spending cash by buying back stock in the market in order to counter the dilutive effect of its employee stock options. Under the proposed design, E would never issue new shares or deliver shares out of treasury, so there is no dilution to counter. In some cases, the cash saved may exceed the cash to be paid by E for the FIOs, depending on projected run rates, stock prices and other assumptions.

  Since E would reduce or eliminate its stock buybacks, would the favorable impact of such buybacks on the market price of E's stock be foregone? Not necessarily. Since F has issued options to purchase E stock, F will be in the market hedging that position by buying stock. Although the market impact of F's hedging activity may not have precisely the same effect as E's stock buybacks, the hedging activity, together with the absence of dilution from the delivery of shares in connection with the exercise of options, should have a similar impact.

- Third, since the FIOs are not dilutive there should be a favorable impact on fully-diluted earnings per share reported by E. This consequence is separate from the effect on the expense required to be reported arising from the grant of the FIOs themselves.

Since E's purchase of FIOs from F involves the actual equity award that is being granted, the design described above would seem to raise no concerns about whether the transaction fairly reflects the value of the award. In particular, the design would seem to eliminate the concerns about ESOARS, or similar instruments, not being properly designed to reflect the price of the underlying employee stock option. Moreover, the design should avoid concerns about whether the price paid in the transaction reflects a fair value for the FIOs. F is presumed to be an institution that is actively engaged in the business of selling over-the-counter options in the regular conduct of its business, and it should be well able to determine how much it can sell them for and will be highly motivated to get the best – that is, highest – price for them. E, by contrast, is highly motivated to pay the lowest price it can for the FIOs, and there are many financial institutions to which it could turn in order to ensure that it does not overpay. The design also eliminates any need for F to be concerned about facts that might be unique to E and its employees, such as the rate and timing of option exercises or forfeitures. This is because F has written ten-year options, and the holder of the option, be it E, an employee to whom the option was granted or another financial institution that bought the option from E or an employee, is entitled to the benefit of the option unless and until F buys it back. Accordingly, concerns about whether the price paid for the FIOs is affected by information flow about future events particular to E would also be eliminated.

Conclusion

The design described above raises many legal and accounting issues. We've considered the legal issues extensively, and the accounting issues have been preliminarily reviewed with the SEC. Any employer that desired to adopt the design, and any financial institution that sought to participate in the program, would probably seek prior regulatory approval with regard to the accounting and some of the legal issues. Nevertheless, the potential benefits seem large compared to the legal and accounting hurdles.

Please feel free to call your regular contact at the Firm, or any of the lawyers listed in the Employee Benefits section of our website, if you would like to discuss these issues further.

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