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SEC Clarifies Views on the Design of Market-Based Employee Stock Option Valuation Model

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Since the issuance of FASB Statement No. 123(R), *Share-Based Payment*, and its requirement to recognize compensation cost for the fair value of employee share-based payments, some companies have been searching for a market-based model for valuing these instruments.[1] Because no such market-based model is readily available, companies have defaulted to pricing models, such as the Black-Scholes-Merton model, to measure an award's grant date fair value. Zions Bancorporation ("Zions") believes, and the SEC concurs, that it has sufficiently designed an instrument to serve as a market-based approach to valuing employee share-based payment awards, including employee stock options. Zions's answer is "Employee Stock Option Appreciation Rights Securities" (ESOARS or the "security").

The security was designed to reflect findings of the SEC's Office of Economic Analysis (OEA) in its review of a market-based approach. The OEA's analysis describes the elements that must be present in a market-based approach to generate a market price that could reasonably estimate fair value as required by Statement 123(R).[2] The memo outlines the key design elements:

1. Instruments should confer net payments on its holders that are equal in value to the fair value of all or part of the employee stock option grant.
2. Registrants should have an information plan that allows buyers and sellers to price the instrument.
3. A market pricing mechanism is necessary to allow the instrument to be traded to generate a price.

It appears that Zions considered all of these elements in designing its instrument and discussed each one in detail in its report and supplemental materials submitted to the SEC. In its report, Zions stated that in the test auction held on June 29, 2006, the valuation derived from the auction suggested a value of 68–72 percent of the value of the same stock option as determined by the Black-Scholes-Merton model.

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[1] Paragraph 22 of Statement 123(R) states, in part, "The fair value of an equity share option or similar instrument shall be measured based on the observable market price of an option with the same or similar terms and conditions, if one is available."

[2] The OEA's memo stated, "The main conclusion of our analysis to date is that instruments that track the future net cash flows of *net obligations* facing the company or *net receipts* by its employees under the option grant can yield reasonable estimates of fair value as defined in Statement 123R."

What Are ESOARS?

ESOARS are derivative securities that provide a market-based model for estimating the grant date fair value of employee stock options. In addition, they:

- Track the value of a referenced pool of employee options (i.e., a tracking stock).
- Pay holders as employee options are exercised.
- Make payments based on a pro rata share of the intrinsic value realized by employees upon exercise of their options in the referenced pool and may be paid in cash, equity, or a combination thereof.
- Are priced upon issuance through an auction held over the Internet.

SEC's Views on the Design of the Security

In the SEC's letter to Zions, the SEC noted that with some modifications, it would concur with Zions's view that ESOARS are sufficiently designed to be used as a market-based approach to valuing employee share-based payment awards under Statement 123(R).

The main modification the SEC recommended making to the design concerned the consideration of forfeitures of the underlying stock options in determining the value of the ESOARS. The SEC noted that, on the basis of the design of the security for the original auction, investors had to consider expected forfeitures of the underlying stock options when determining the price they were willing to pay for ESOARS. However, Statement 123(R) prohibits the consideration of forfeitures when determining the grant date fair value of a share-based payment award. To address the SEC's concerns about forfeitures,[3] it appears that Zions will modify the design of the security such that refunds will be provided to investors for their pro rata share of stock options within the referenced pool that do not ultimately vest.

SEC's Views on the Market Mechanism

Although recommending these modifications, the SEC appeared to express a positive view on the ESOARS design. However, the SEC's view on the market mechanism built for ESOARS was not so definitive. The SEC expressed concern that, because of several factors, the value produced by the original auction may not have been representative of the fair value of the underlying stock options and encouraged Zions to share with the SEC results of future auctions. The SEC also clarified that in the future, each ESOARS auction should be analyzed individually to determine whether its results yielded an appropriate pricing mechanism. This analysis should consider factors including, but not limited to:

- Size of the offering relative to the demand.
- Number and characteristics of the bidders.
- Technology issues.
- Bidder perception of the costs of holding, hedging, or trading the instrument.

How Does This Security Work?

There are four possible outcomes for an employee stock option: exercise, forfeiture, modification, and cancellation. The following chart depicts the consequence of each outcome for holders of the security, as modified for the SEC's comments:

[3] As described in its letter to the SEC, Zions noted that the ESOARS could be modified by either (1) publishing the pre-vesting forfeiture estimate in the offering documents and structuring the payments to ESOARS holders to reflect deviations from the estimate or (2) refunding to ESOARS holders their share of the ESOARS purchase price paid for share-based payment awards that do not vest. The SEC believes that both approaches would allow investors to eliminate consideration of the forfeiture rates when determining their purchase price.

Outcome	Consequence
Exercise	Holder receives pro rata payment for its share of the intrinsic value realized by the employee when the stock options in the referenced pool are exercised.
Forfeiture	Unvested options — holder will be reimbursed, with interest, for its pro rata share of the amount paid for forfeited stock options in the referenced pool. Vested stock options — holder will receive no reimbursement.
Modification	ESOARS holder will receive a pro rata payment based on an independent valuation of the ESOARS at the time of the modification.
Cancellation	From the available information, it is unclear how ESOARS are affected by cancellations.[4]

Accounting for the Security

Accounting for this security will vary depending on its terms. The security's settlement options may be designed for settlement in cash, equity, or a combination thereof, which could affect the measurement and classification of the ESOARS. Because this security is a freestanding derivative, companies will need to evaluate how the instrument is classified and how subsequent changes in this instrument's fair value are reported. Further, if reporting of subsequent changes in the fair value is required, companies will need to consider how the fair value of the ESOARS will be determined on an ongoing basis.

Even if ESOARS are structured to be equity settled, at issue is whether this instrument is deemed indexed to the company's own stock. EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock,'" indicates that instruments are considered indexed to a company's own stock as long as the contingency provisions are not based on (1) an observable market, other than the market for the issuer's stock (if applicable), or (2) an observable index, other than one calculated or measured solely by reference to the issuer's own operations, **and** once the contingent events have occurred, the instrument's settlement is based **solely** on the issuer's stock.

For ESOARS, the contingency provisions appear to be driven in part by an employee's choice of whether to exercise an underlying option. This raises the question of whether the contingency provisions are based on something other than an observable market or index related to the company's stock or operations, respectively. In addition, unvested forfeitures will result in the reimbursement to the holder of the security, with interest, for its pro rata share of the amount paid for forfeited options in the referenced pool. Issuers will need to evaluate the terms of the arrangement to determine whether the forfeiture settlement alternative (as well as the other settlement alternatives) is based solely on the issuer's stock. To the extent that ESOARS are not deemed indexed to the company's own stock, issuers would be required to record changes in the fair value of this security through the income statement at each reporting period.

What about dilution? To the extent that this security is equity settled, companies will need to evaluate whether the security should be included in their calculation of diluted earnings per share.

Other Considerations

Companies should consider using valuation specialists to analyze individual offerings when supporting management's assertion that auction results yield an appropriate pricing mechanism (the factors noted above should be considered). As stated above, in the letter to Zions, the SEC encourages the continued sharing of results and analysis of future auctions with the SEC. Companies thinking about using ESOARS or other securities to serve as a market-based approach to valuing their share-based payments should consider preclearance with the SEC.

[4] As discussed in paragraph 57 of Statement 123(R), cancellations that are not accompanied by a replacement award (1) do not result in the reversal of previously recognized compensation expense and (2) result in the recognition of any unrecognized compensation expense at the cancellation date.

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