

# Client Alert

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## SEC Staff Approves Market-Based Approach to Valuing Stock Options

Last week, the Securities and Exchange Commission (SEC) approved a technique for valuing stock options for financial statement purposes which may, in many cases, lead to a lower earnings charge.

On January 25, 2007, the SEC's Chief Accountant, Conrad Hewitt, issued a letter to Zions Bancorporation, concurring with the conclusion that a new instrument, known as "ESOARS" (described below), may be used as a market-based approach to valuing employee stock options and other share-based payment awards under FASB Statement No. 123R, "Share-Based Payment" (Statement 123R).

According to Zions Bancorporation, the ESOARS instrument is designed to provide a publicly-traded corporation with a way to determine the fair value of its employee stock options using a market-based approach. This market-based approach is intended as an alternative to one of the commonly used model-based approaches (such as the Black-Scholes model). The SEC previously described market-based approaches for estimating the fair value of employee stock options under Statement 123R in a memorandum from the SEC's Office of Economic Analysis, released in September 2005.

ESOARS (which is the acronym for Employee Stock Option Appreciation

Rights Securities) are securities designed to be issued by a large capitalization (generally, in excess of \$700 million), publicly-traded corporation that is a "well-known seasoned issuer" (WKSI). The ESOARS would be tracking securities that track the value of a reference pool of the corporation's employee stock options granted on a specific date. Payments would be made to the holders of the ESOARS, in cash or the corporation's stock, as the options in the reference pool are exercised. The payments would be based on the intrinsic value realized by the employees when they exercise their employee stock options. Also, certain payments would be made when options are forfeited prior to vesting. The reference pool would represent a percentage (at least 10 percent) of the payments that would be made under the employee stock options.

A corporation's ESOARS would be sold in an offering under the corporation's universal shelf registration in connection with the corporation's grant of employee stock options. The ESOARS would be offered in a modified "Dutch" auction, which would take place on or soon after the grant of the employee stock options. In the auction, the ESOARS would be allocated to the investors submitting the highest bid prices and would be sold at the "market-clearing price." The clearing price in the auction would be

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used to determine the fair value of the employee stock options for purposes of Statement 123R. The corporation's ESOARS would be derivative securities that are separate from the employee stock options and, consequently, are designed to have no effect on the corporation's grant of employee stock options (or the employees who are granted options).

The SEC letter explains that an ESOARS auction would need to be analyzed to determine whether it results in an "appropriate market pricing mechanism." Specifically, the SEC letter explains that the analysis should determine if the auction clearing price is representative of the fair valuation of the underlying employee share-based payments. The SEC letter notes that a market-based approach must ensure appropriate levels of competition and liquidity in the market for the instrument used to determine fair value. In addition, the SEC letter suggests that the management of the issuing corporation may find it useful to compare the auction results with the estimated fair value derived through broadly accepted modeling techniques. Thus, a corporation's management and accountants would need to decide whether it is appropriate to use the fair value determined under a particular ESOARS auction for purposes of valuing employee stock options under Statement 123R. Also, the corporation's management would need to work with its legal advisors to prepare and register the ESOARS offering in connection with a proposed grant of employee stock options.

Given the SEC's recent approval of the ESOARS instrument as a market-based valuation approach, publicly-traded corporations may want to consider utilizing a market-based approach in valuing employee stock options under Statement 123R. The corporation's management and accounting and legal advisors would need to consider carefully whether a market-based approach was appropriate, and the financial, accounting and legal consequences of offering the derivative securities to be used in the market-based valuation approach. A market-based approach offers a promising alternative to the model-based approaches, but time will tell whether such an approach will gain acceptance from accountants for publicly-traded corporations.



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