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# **Zions Bancorporation: SEC Acknowledges Significant Progress in Developing a Market-Based Valuation for Employee Stock Options**

## I. Background

As of January 1, 2006, public companies are required to recognize as an expense the fair value of stock options granted to all their employees. The accounting literature which compels this is Statement of Financial Accounting Standards No. 123R ("FAS 123R"), *Share-Based Payment*, which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation.* [1,2] FAS 123R permits companies to utilize one of three alternate approaches for valuing employee stock options:

a closed-form model such as the Black-Scholes option-pricing formula;

the binomial (lattice) method; and

market-based valuation.

In the year since compliance with FAS 123R has been required, the Black-Scholes option pricing formula has been commonly used for determining the fair value of employee stock options for the purpose of recording the expense associated with their issuance as FAS 123R requires. No use has been made of the market-based valuation approach chiefly because establish-

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1 http://fasb.org/pdf/fas123r.pdf

2 Historically, companies accounted for share-based compensation, including stock options, under Accounting Principles Board Opinion No. 25 ("APB 25"), *Accounting for Stock Issued to Employees.* Under APB 25, companies typically did not record any compensation expense with respect to stock options granted prior to 2006 because, in general, procedures were utilized to assure that the exercise price of the options was equal to the quoted market price of the common stock underlying the option on the date of grant.

ing a market valuation for employee stock options for which there is no trading market has heretofore not been viewed as a practical alternative.

In a letter dated January 25, 2007 (the "Letter"), the Chief Accountant of the Securities Exchange Commission ("SEC") advised Zions Bancorporation ("Zions") that a derivative security created by Zions and sold by it pursuant to an auction procedure represented "significant progress in identifying a suitable market-based approach to valuing employee share-based payment awards."[3] The SEC's letter to Zions has been portrayed in the press as a milestone which clears the way for companies wishing to use a market-based valuation approach for FAS 123R purposes. Some believe that using such an approach will produce a lower valuation for stock options than that obtained using a Black-Scholes pricing formula. If that is the case, a company using a market-based approach will be able to record a lower expense associated with the issuance of employee stock options than would have been the case had it used one of the other valuation methods permitted by FAS 123R.[4]

While the Letter is approving of Zions' approach, it requires Zions to make a number of modifications to the procedures used by Zions in developing its market based approach. Therefore, it remains to be seen whether Zions will be successful in implementing the process it has devised with the modifications requested by the SEC. In addition, because Zions has made patent claims with respect to certain elements of the procedure it has developed, whether others will be willing to pay license fees to Zions for use of these elements (assuming Zions' patent claims are granted and survive any challenges) is an open question.[5]

A brief description of Zions' approach and the SEC's suggested modifications thereto follows.

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3 *See* SEC letter dated January 25, 2007 addressed to Zions Bancorporation available at http://www.sec.gov/info/accountants/staffletters/zions012507.pdf

4 Zions estimated that the valuation derived from its June 2006 auction of ESOARS was in the range of 68% to 72% of the valuation which would have be obtained using the Black-Scholes valuation formula. See, "Zions Bancorporation ESOARS" (September 22, 2006) submission prepared by Zions for the Office of Chief Accountant of the SEC (the "Zions Submission") at 17, available at https://www.esoarsauction.com/pma/faq/zions_submission.pdf

5 Zions announced that it has a patent pending on its ESOARS design and market pricing mechanism. See Zions' press release dated 1/30/07 at http://www.snl.com/irweblinkx/file.aspx?IID=100501&FID=3348303

## II. Zions' Market-based Approach

### A. ESOARS

There are two keys to Zions' approach: the first is a derivative security which Zions has named Employee Stock Option Appreciation Rights Securities ("ESOARS"); second is the public sale of ESOARS by auction.[6] The first Zions auction of ESOARS occurred in June 2006.[7] As stated in the Prospectus, the ESOARS were expressly designed to provide a market basis for estimating the fair value of stock options granted to employees consistent with the requirements of FAS 123R.

The Zions' ESOARS were issued with reference to a specific pool of Zions employee stock options.[8] ESOARS are not stock options themselves. ESOARS are simply payment obligations of Zions which are triggered when options in the referenced pool are exercised. ESOARS holders receive payment when three factors converge: (i) employee options in the referenced pool vest, (ii) the stock price exceeds the option exercise price, and (iii) an employee who holds options in the referenced pool exercises the options.

The number of ESOARS Zions chose to issue in June 2006 corresponded to 10% of the number of employee stock options in the referenced option pool. Upon the exercise of stock options in the referenced pool, Zions therefore is obligated to pay the ESOARS holder an amount equal to 10% of the excess of the market price of Zions' stock over the exercise price of the referenced options.

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6 It is noted that in structuring and marketing the ESOARS, Zions "carefully followed" the guidelines set forth in a memorandum issued by the SEC's Office of Economic Analysis, *Economic Evaluation of Alternative Market* instrument designs*: Toward a Market-Based Approach to Estimating the Fair Value of Employee Stock Options* (August 31, 2005) (the "SEC Memorandum") available at http://www.sec.gov/news/extra/memo083105.htm; see, Zions Submission at 18.

7 The June 2006 ESOARS offering was intended by Zions as an experiment to test the viability of ESOARS as a market-based employee stock option valuation method. Zions therefore did not use the results of that offering to value the referenced employee stock options. Zions Submission at 2. See also the June 29, 2006 Prospectus for Zions' ESOARS offering (the "Prospectus") available at
http://www.sec.gov/Archives/edgar/data/109380/000095012906006992/h36810b2e424b2.htm

8 The 93,610 ESOARS issued sold for a price of $7.50 per Unit to 21 winning bidders. See, Zions Submission at 15.

### B. The Public Auction

The second key to Zions' approach is the sale of ESOARS through a public auction. It is through use of an auction that Zions' seeks to derive a market valuation for ESOARS. The ESOARS auction was conducted on a dedicated website over a two business day period. In general, the auction process was modeled after that used by the United States Treasury, with some notable differences. The auction was an "open" auction, with bidders being updated on the status of their bids relative to other bidders. At no point, however, did bidders have access to other bidders' actual bids or other bidders' identities. The terms and conditions for participation in and the conduct of the auction were set out in detail in the ESOARS Prospectus and are further described in the Zions Submission.[9]

## III. The Letter

The Letter concurs with Zions that the ESOARS instrument "is sufficiently designed to be used as a market-based approach to valuing employee share-based awards under" FAS 123R. However, the Letter requires that Zions make two modifications in its approach in order for it to meet the requirements of FAS 123R.

### A. Modifications to ESOARS

First, the Letter notes that FAS 123R precludes consideration of forfeitures when estimating the grant date fair value of employee stock options. In contrast, the right to payment under Zions' ESOARS is affected by the forfeiture rate in the referenced pool of options. Therefore, investors in ESOARS would be expected to take this factor into account in valuing the ESOARS. The SEC stated that in order to comply with the requirements of FAS 123R, the ESOARS would have to eliminate consideration of forfeiture rates so investors would not utilize that factor in valuing the ESOARS.

The Zions Submission anticipated the SEC's comments and proposed two possible modifications of the ESOARS to address the issues later raised by the SEC in the Letter. The first mechanism would adjust the payment to investors using a formula which would take into account actual option forfeitures as compared with forfeiture rates estimated by Zion based on historical experience and presented to investors in prospectuses covering the offer of ESOARS. As another alternative, Zions proposed to refund to holders of ESOARS their share of the ESOARS purchase price paid for options that do not vest.[10] According to the SEC, as expressed in the ESOARS Letter, once one of these two methods is implemented in the structure, the ESOARS will be sufficiently designed to be used as a market-based valuation approach under Statement 123R.

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[9] See Prospectus at S-13 and following; Zions Submission at 11 and following.

[10] Zions Submission at 19.

**B. Modifications to Auction Process**

The Letter also sets forth that having an appropriate market pricing mechanism and related information plan is critical in order to reach the estimation of fair value of the underlying employee stock options when using a market-based approach.[11] In light of the foregoing, the SEC recommended that Zions' auction system be revised in order to determine whether it results in an appropriate market pricing mechanism. Factors that should be considered include, but are not limited, to: (i) the size of the ESOARS relative to market demand, (ii) the number of bidders, (iii) technology issues (including delays), and (iv) bidder perception concerning the costs of holding, hedging or trading the instrument.

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The Letter, as well as the SEC Memorandum, encourage efforts to develop a market-based valuation approach over the model-based approach. In the view of the SEC, among the advantages presented by the market-based approach are:

- The market price can efficiently reflect a consensus view among informed marketplace participants about an expense, asset or liability's utility, future cash flows, the uncertainties surrounding those cash flows, and the compensation that marketplace participants demand for bearing those uncertainties.

- The instrument's price could establish the true opportunity cost of the award to the issuer by having it priced by the market.

- Use of a market instrument may promote competition between different approaches to the estimation of the value of the market instrument, and thereby lead to innovations in models and techniques used to price employee stock options.

- There could be a positive externality for other firms that could use market prices to help improve their calibration of model-based estimates.

The SEC believes that ESOARS constitute a significant progress in identifying a suitable market-based approach to valuing employee share-based payment awards. In light of that belief, it is expected that further efforts will be made to develop a market-based method for determining the fair value of employee stock options for purposes of FAS 123R.

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11 The Letter notes that Zions' June 2006 auction may not have been sufficient for FAS 123R purposes noting that a "two minute rule mechanism, and technological delay" may have contributed to a market-clearing price for ESOARS that may not have been representative of the fair value of the referenced employee stock options. Letter at 2; Zions Submission at 16-17.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; or Maria Brito at (212) 701-3668 or mbrito @cahill.com.