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THE NEWSLETTER FOR THOSE THAT ADVISE PUBLIC COMPANIES

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The Latest Proxy Disclosure Guidance

Note: Because of the heightened need for proxy disclosure guidance during the critical days and months ahead, David Lynn, former SEC Chief Counsel, will be writing the lead piece in each issue of *The Corporate Executive* this coming year, providing the latest compensation disclosure guidance and pitfalls.

—*JMB*

Key Executive Compensation Takeaways from Our Conferences

Throughout the course of our "2nd Annual Executive Compensation Disclosure Conference," our "Hot Topics and Practical Guidance Conference: *The Corporate Counsel* Speaks" and our "4th Annual Executive Compensation Conference," the panelists and keynote speakers covered a great deal of ground on how to improve the executive compensation process and executive compensation disclosure. While there is no substitute for listening to the panels and reviewing the course materials yourself—which you can still register to do at TheCorporateCounsel.net or CompensationStandards.com—we are highlighting some of the notable takeaways that everyone needs to be aware of.

A Call for Analysis—John White's Keynote Address

Timed to coincide with the opening of our "2nd Annual Executive Compensation Disclosure Conference," the SEC Staff released its "Observations in the Review of Executive Compensation Disclosure." While much of the content of that report was discussed in our analysis of the Staff's comment letters in our last issue, John White, Director of the SEC's Division of Corporation Finance, delivered a major keynote address highlighting the most important observations from the Report and some truly practical guidance for addressing the Staff's principal concerns. This is one of the strongest speeches from the SEC Staff to date on the topic of executive compensation disclosure.

John White indicated there have been positive developments with the first year of executive compensation disclosure under the new rules. However, he said that more work needed to be done for next year. The focus for that work, in White's view, needs to be on the required analysis in the Compensation Discussion and Analysis. As we have noted, companies came up short on the analysis this year in the CD&A—leading the Staff to ask "where is the analysis?"

As John White noted, the Staff expects issuers to take all of the guidance provided to date on the CD&A to heart in preparing next year's disclosures. The focus of the Staff's comments next year, as well as its other potential reactions—which could include referrals to the Division of Enforcement—will relate to how well issuers have implemented the Staff's efforts toward improving analysis in the CD&A. While much of this guidance has already been the subject of prior Staff guidance and our own guidance (see the special Supplement to the September-October 2006 issue of *The Corporate Counsel* (at pg. 1) and our September-October 2007 issue), it is clear from White's remarks that the Staff is serious that the guidance must now be heeded.

Use the Analytic Tools

As a result, boards and their advisors need to start using the key analytic tools necessary to make informed compensation decisions, which

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in turn will facilitate the required analysis in the CD&A. Key analytic tools such as tally sheets, an internal pay equity analysis and a wealth accumulation analysis (which John White specifically mentioned) are necessary to help achieve what he said that the SEC wants: a CD&A that "should focus on the material principles underlying the registrant's executive compensation policies and decisions and the most important factors relevant to the *analysis* of those policies and decisions." Without the analytic tools in place, there is no framework for providing a discussion of the factors relevant to the analysis and thus no way to put the compensation numbers into perspective.

Presentation Matters

Once the necessary analytic tools are fully implemented and there is an appropriate level of analysis in compensation decisions that may then be presented in the CD&A, John White emphasized that "presentation matters." The manner of presentation—which is not just limited to plain English concepts—is something with which the Staff is very concerned. White emphasized that in situations where the Staff asks an issuer to add or enhance its analysis, it does not necessarily follow that the disclosure must be longer. As the Staff noted in its Report, boilerplate discussions of individual performance may be replaced by specific analysis of how individual performance was considered and used in determining individual compensation. Further, rather than repeating information that is also presented in the required tables, issuers should replace redundant disclosure with the required analysis. Finally, reducing technical language regarding plans to clear and understandable descriptions can also open up page space for more of the much-needed analysis. [A key point that John White made (and reinforced by Paula Dubberly, Associate Director (Legal) of the SEC's Division of Corporation Finance, on her panel) was to move the discussions out of the CD&A and, instead, have them accompany the tables—thus freeing up the CD&A for analysis.]

Presentation also matters in the way that the CD&A itself is structured, and John White noted that including a separate section entitled "Analysis"—as noted in the September-October 2007 issue of *The Corporate Counsel* (at pg 1)—is one of many good ideas for ensuring the proper emphasis on analysis in the CD&A. The use of a layered disclosure approach, and presenting information in charts and tables—while at the same time avoiding laundry lists of facts—will enhance the presentation, while at the same facilitate (and make room for) the necessary analysis.

A One-Page "Clean Slate" List

John White ended his remarks with a useful suggestion—a tool that will facilitate the necessary rewrite of the CD&A this coming proxy season. He suggested that everyone on the disclosure team be required to come up with a one-page "clean slate list," which is to focus on the key "hows" and "whys." He provided three bulleted items to include:

- the key analytic tools used by the compensation committee;
- the findings that emerged from the analysis; and
- the resulting actions taken impacting executive compensation in the last year.

With this latest round of guidance, the Staff has shown us the path toward the CD&A disclosure that the SEC intended and that the Staff now expects. There will be no "passes" next year for missing analysis!

The Upcoming January-February Issue of *The Corporate Executive*

To assist our readers in putting the Staff's CD&A guidance into practice, we are right now preparing the upcoming issue of *The Corporate Executive*, where we are providing examples of model analysis language to illustrate what the Staff will now be looking for in the CD&A.

To get these examples into readers' hands now—as you begin to prepare your CD&As—we will post an Advance Copy of the January-February issue during the first week of December. The issue can be accessed by all 2008 subscribers to *The Corporate Executive* by going to the home page of TheCorporateCounsel.net and then clicking on the prominent link to the issue.

How Much is Enough?

The Conferences demonstrated that real momentum is building for fundamental shifts in the way that boards look at executive compensation

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policies and programs. This trend was underscored in the kick-off panel at the "4th Annual Executive Compensation Conference," where the panelists addressed the need to rethink everything—from routine equity grants to severance and retirement benefits. In many ways, the SEC's focus on analysis in the CD&A should serve as the catalyst for boards to reconsider the "whys" and the "hows" of their executive compensation approach—and to implement the tools such as internal pay equity and wealth accumulation analyses in a manner that will produce tangible results.

Ira Kay—head of Watson Wyatt's compensation practice, who has strongly defended the current executive compensation system—noted on the panel that the SEC did compensation committees a huge favor by requiring at least the raw data about post-employment compensation (if not the total walk-away number) in the proxy statement. Kay believes that if companies want to sustain their successful incentive model of executive compensation, they need to revisit the need for cash severance. Throughout the conference, panelists discussed how severance benefits need to be considered in light of the executive's accumulated wealth, and how severance benefits for new executives should be subject to sunset provisions whereby they can be eliminated following a relatively short transition period of three to five years. On the topic of the interaction between a wealth accumulation analysis and post-termination compensation, Mike Kesner, who heads Deloitte's executive compensation practice, noted that people are beginning to consider how severance pay could be stepped back or eliminated based on the level of wealth accumulated.

Beyond severance pay, panelists discussed how—once armed with complete accumulated wealth information and the internal relationship of pay among executives within the company—compensation committees and boards can now start to reconsider the need to continue granting annual equity awards, to continue providing perquisites, or to establish or maintain supplemental pension and other post-employment benefits. The light shining on these decisions through increased analysis in the CD&A necessitates action now, as those who lag behind will surely stand out in the upcoming proxy season.

Improving Your Executive Compensation Disclosure Now

Panelists highlighted many thoughtful ways in which executive compensation disclosure can be improved in the upcoming proxy season. Here are a few such suggestions:

Compensation Discussion & Analysis. When making decisions regarding the disclosure or non-disclosure of performance target levels in the CD&A, companies need to be prepared to defend those decisions with adequate arguments supporting confidential treatment. Further, they need to be prepared to defend quantitative and qualitative performance measures to demonstrate—in the disclosure—how the amounts received actually reflect pay for performance. In this area, as with other elements of compensation to be described in the CD&A, the focus must be more on details of what actually occurred and the issues that the compensation committee actually wrestled with, while not getting bogged down in things that are not material. When performance target levels are omitted, the most effective "degree of difficulty" disclosure focuses on the historical perspective of how often the similar targets have been met, along with the necessary additional quantitative and qualitative information to explain the past performance target experience.

Summary Compensation Table. Paula Dubberly emphasized that the required format of the tables, including the SCT, cannot be changed. If a particular compensation element is highlighted through an additional column or a supplemental table, then that element is likely something that needs to be addressed in the CD&A. In some instances, the Staff found that footnotes were difficult to follow and the presentation would have been improved by including the information in the narrative required to accompany the table.

With regard to the presentation of an "alternative" SCT, while the Staff has not acknowledged that these tables are often necessitated by the December 2006 rule changes modifying the presentation of equity awards, it has not objected to presenting this information when appropriate. The Staff's comments have focused on whether the alternative presentation is inappropriately given greater prominence than the required SCT, whether the supplemental table is presented in a manner that does not adequately distinguish it from the required disclosures and on whether the differences between the supplemental and required tables are adequately described. [As stated in the September-October 2007 issue of *The Corporate Counsel* (at pg 3), we very much liked the way Citigroup handled its alternative disclosure.]

Perquisites. Given the requirements to disclose all perks (including those for which there is no cost) once the $10,000 threshold is crossed, our panelists noted that issuers need to cast the net widely, because in the area of perks it is always better to be safe than sorry. Once an item that could potentially be considered a perk is identified, then you should apply the two-part test outlined in the SEC's adopting release. Mark Borges of Compensia noted that with perks in particular, issuers and their executives are "guilty until proven guilty" so presentation matters. Presenting the perks in a clear manner, such as through the use of a table and clear accompanying text, is the way to address this issue head-on.

Incremental Cost Heads-Up. Finally, this past year's proxy disclosures of how issuers were computing aggregate incremental cost revealed that many issuers are significantly understating the incremental cost of the use of corporate aircraft by failing to include dead head costs (which can increase costs as much as two to four times the amount disclosed) and the loss of corporate tax deductions.

The 15-minute eye-opening presentation by Brink Dickerson of Troutman Sanders and the accompanying materials are a "must" for anyone preparing the airplane perk disclosure numbers.

Those that failed to address the taxation aspect of personal airplane usage will find Dickerson's guidance helpful. We expect his best practice disclosure example (and the example we will be providing in the upcoming issue of *The Corporate Executive*) to become the standard for proxy disclosures this year.

Termination and Change-in-Control Arrangements. The disclosure required about termination and change-in-control arrangements highlights that the analysis must go beyond the numbers to address why the issuer put in place or modified—or is maintaining—a change-in-control arrangement, severance agreement or employment contract. These questions are particularly relevant when, for example, the executive already has accumulated significant wealth and no longer has a need for a safety net. This is an area where issuers and their advisors must pay particular attention to what is said in the disclosure—too often they can be trapped in a situation trying to justify an arrangement for which there is no adequate justification.

The disclosure issues around termination and change-in-control arrangements underscore the fundamental problems with these compensation elements. As the Staff has suggested in many of its comment letters—and as it noted in its Report—"to enhance investor understanding of these tables" issuers should "disclose the total amounts they would be required to pay their named executive officers upon termination or a change-in-control." As discussed above, a total "walk-away" number has the added benefit of enhancing the compensation committee's understanding of the cost of these benefits. Further, as noted in the September-October 2007 issue of *The Corporate Counsel* (at pg 3), disclosing the walk-away number is the best means of avoiding unwanted surprises down the road if the termination or change-in-control provisions are ultimately triggered.

—DL

Google's Transferable Stock Options—Follow-Up

Google's presentation on its "teesos" at the recent NASPP Conference provided some additional information on the program (which we featured in our May-June 2007 issue at pg 1 and also discussed in the May-June 2007 issue of *The Corporate Counsel* at pg 1).

More Overhang, But Less Dilution (While Sold TSOs Remain Outstanding)

TSOs increase "overhang" in that the company's stock options remain outstanding longer (i.e., the date the employee sells the option would otherwise be the exercise date, after which the option typically would no longer be in existence and the option shares would go from the overhang numerator to the denominator (decreasing overhang). Here, however, on the employee's exercise/sale date, the option converts to a warrant that will be outstanding for two more years (as we discussed, the investor has no reason to exercise the warrant prior to expiration, but might sell to another investor who would hold to term). [As we pointed out in our

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May-June discussion (at pg 3), the Black-Scholes value of TSOs increases because of the longer expected term until exercise, *i.e.*, the expected employee exercise/sale date plus two years.]

On the other hand, EPS dilution is reduced post-sale, while the warrants remain outstanding, because (after transfer) the options/warrants are still treated as common stock equivalents until they are exercised, *i.e.*, are excluded from basic EPS and are only included in the diluted EPS denominator to the extent of the treasury stock method, which means that the number of option shares included in the denominator is reduced by the number of shares the company could buy back using the exercise proceeds (after the option is transferred the "proceeds" would not be deemed to include any tax benefit to the company, there being none at that point—see our May-June 2007 issue at pg 7). Eventually, when the warrants are exercised, the full number of shares will be added to the EPS denominator (except to the extent the company actually uses exercise proceeds to buy back shares—more in an upcoming issue on the EPS impact of stock buybacks), the same as when a traditional (*e.g.*, non-transferable) option is exercised.

Google's Income Tax Ruling

Google did indeed obtain a Private Letter Ruling from the IRS confirming that there is no Section 83 (or other) taxable income on grant of TSOs (or on the deemed grant occurring when a pre-existing option is modified to become a TSO), *i.e.*, there is no "readily ascertainable fair market value." See PLR 2007-08002 (August 14, 2006, released February 23, 2007). We had wondered whether Google had the time to obtain a ruling, but it turns out that Google had been working on implementing a TSO program almost since the ink was drying on its 2004 IPO. [To date, there are over 2,800 year 2007 PLRs on irs.gov; names obviously are not provided, and word searching for PLRs can be a nightmare.]

Section 409A. The last hurdle Google faced before implementing the program was getting comfortable that TSOs would not be deemed to be discounted stock options, triggering Non-Qualified Deferred Compensation for Code Section 409A purposes, even though granted at the market price of the stock, because of the value of the option privilege that employees would now be able to realize. In other words, an option for 100 shares at $10 might immediately be salable for $1 or more on the date of grant (ignoring vesting).

Google apparently found that comfort when the Section 409A Regs were published in April (see Reg. 1.409A-1(b)(5)(i)(A)(1)). As we discussed, modification of outstanding options to add transferability was not a Section 409A discount problem for Google, because Google's plan provides the right to make the options transferable.

Google wasn't concerned about the same discounted option issue in the Section 162(m) context, as Google's TSO program excludes executive officers. For companies that do wish to include NEOs, §162(m) would appear to be applicable to Google-type TSOs because compensation derived from sale of a TSO is not solely from increase in the stock price and, therefore, might not be performance-based per the §162(m) Regs. A ruling request may be in order here. [One solution may be to condition TSO status of an option on a performance goal, so that the option becomes like any other §162(m)-excluded performance compensation.]

Tax Withholding on Actual Sale Price

As our readers know, tax withholding is computed based on the amount of (wage) income realized on the exercise of an employee stock option with a typical same-day sale to exercise a non-transferable option, the taxable spread realized may be based on (i) the employee's actual sale price, or (ii) the closing or mean market price, depending on the company's practice. If (ii), there could end up being a small gain or loss, or none. If (i), the broker's commission payable by the employee results in a capital loss in that amount. [See our March-April 1992 issue at pg 1.]

When a TSO is sold, the actual (entire) sale price (not just the market price spread) is the taxable amount. But here, we think the taxable amount is the *net* sale proceeds. The broker's commission (and other transaction costs) should not result in a capital gain or loss; there is no capital asset being sold here (and no Schedule D to be filed).

Shareholder Approval of Plan Amendment Necessary to Implement Program

Most extant plans aren't broad enough to allow the transfer/sale of plan options beyond "family members," or the conversion of sold TSOs to two-year warrants. (Google's plan, adopted pre-its IPO, specifically is—see plan Sections 2(e) and 4(b).) As we discussed, a plan amendment of this kind likely would require shareholder approval under the SRO approval rules, although adding transferability doesn't seem to be specifically addressed in the NYSE FAQs.

ISS. The good news here is that ISS, etc. likely would be supportive. In fact, the main purpose of the program is to create more value to employees with the same number of options (or, preferably, the same return with fewer options). ISS's policy does require that the company submit the program for shareholder approval. In addition, they have more rigorous requirements for a one-time TSO program (à la Microsoft—see our September-October 2003 issue at pg 1), including non-participation by officers and directors and a two-year minimum holding period on sale proceeds.

Their main requirement for an ongoing program seems to be that the structure and mechanics be adequately disclosed to shareholders (presumably, in the plan approval or amendment process) and in sufficient detail to enable ISS, etc. to "model" the cost of the program; moreover, for some reason, ISS doesn't want to see even an approved program used to convert previously outstanding grants into TSOs. [ISS seems to think that forfeiture rates (under 123(R)) wouldn't be applicable in costing TSOs, but this could only be true for options that are transferable prior to vesting—a cost/value reduction for forfeitures is still applicable where the options aren't transferable until vested.]

Program Results to Date

Google reports TSO sale results quarterly in its 10-Q/K, in their Stockholders' Equity footnote (where they put all of their disclosures related to stock compensation). To date, TSO sellers have received approximately a 10-15% premium above the option spread on the sale date. In its September 30 Form 10-Q, Google reports an average premium of 12.7% on total sales (since inception in April) of $143.7 million for TSOs for 539,927 shares; TSOs for an additional 7,165,702 shares were outstanding at September 30. (We're talking real money here!)

Bid prices shown in the auction are for a maximum of 1,000 shares, but employees can sell in multiple 1000-share lots. Quotes above 1,000 shares are available.

Google says "virtually all" eligible employees are selling their TSOs rather than exercising (forgoing the option premium). But, for some reason, not everyone.

Relationship of Premium to Black-Scholes Value. The disclosure doesn't tell us what the Black-Scholes, etc. value of the sold TSOs was on the sale date. Extrapolating from available information, we think employees are receiving approximately the Black-Scholes value at the time of sale of the truncated options/warrants.

Citigroup's TSO Entry. Bill Ortner of Citigroup, which is creating its own version of Citi-Issued Transferable Options, questions our observation (in our May-June discussion) that Zions' ESOARS experience (updated below) may be evidence that Google employees' TSO sales would realize significantly less than the Black-Scholes value. He thinks employees should receive the full Black-Scholes value of the truncated options/warrants they are selling, which won't be exercised until full term. Seems he may be correct. [Ortner says that, unlike Google's TSOs (and, presumably, Citigroup's version), ESOARS (which are sold at the time of grant of the underlying stock options) are doomed to realize less than Black-Scholes because investor returns are tied to employees' whim of the timing of exercise of the underlying options. If the point here is that institutional buyers may extract a discount for unexpected behavior by option holders, we get it. On the other hand, Black-Scholes itself takes into consideration, *i.e.,* discounts the value, by assuming/expecting exercise prior to expiration.]

Selling the TSO, and Then Buying the Shares, Can Increase Return. Ortner also points out that, in our example (at pgs 4-5 of our May-June TSO discussion) comparing a Google employee's selling a 1,000-share TSO vs. exercising and holding for one year (to get long-term capital gain taxation on appreciation during that year), a better result (given the employee's decision to exercise rather than just wait a year) would be to sell the TSO and then buy 1,000 Google shares in the market (using the after-tax proceeds from the TSO sale, plus a third-party loan—not a likely scenario for non-executives). That way, the employee receives the time value of the TSO on the sale and still gets the appreciation/capital gain during the holding period year, increasing over-

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all gain by 16% (in our example); eat/sell your TSO and still have it!

Net Exercise Upon Expiration of Warrants

The sold options/warrants (held by the institutional buyers) provide for either cash exercise or, at Google's discretion, issuance of the net shares a la a stock SAR. For now, Google intends to effect net exercises. And, if an option holder fails to take action to exercise at expiration, the warrant will automatically be net-exercised (akin to the prevailing practice with traded options). Interestingly, while the liberal share counting provision in Google's plan (Section 3.[illegible]) essentially nets out everything else, shares subject to sold TSOs don't go back into the plan pool, if net exercised or possibly even if a warrant expires underwater; we're not sure of the rationale here.

Only Google?

So far, there hasn't been a groundswell to implement TSO programs, despite the benefits of pioneering by Google (and its counsel, David Segre and Ralph Barry of Wilson Sonsini Goodrich & Rosati in Palo Alto), Morgan Stanley and Smith Barney (Google's stock plan administrator). Perhaps the effort and expense are justified only at the largest issuers with upwardly volatile stock, where big bucks are involved.

Other possible disincentives include (i) the increased accounting costs resulting from the longer period until exercise, albeit 123(R) non-cash charges seem to be widely disregarded these days (see pg 11), (ii) the tendency of the program to encourage early exercise/sale (because employees can realize a greater amount of gain than with non-transferable options), (iii) that sale of a TSO results in immediate disposition of all the option stock, so no ownership incentive lingers (with typical exercises, on the other hand, employees in theory can end up retaining a portion of the shares in excess of the amount necessary to pay the exercise price and withholding), and (iv) §409A and §162(m) issues. Another possible hindrance is that the company's receipt of exercise proceeds is deferred, *i.e.*, until two years after the employee's "exercise", which obviously isn't a problem for some companies.

SEC Registration Follow-Up

In the upcoming November-December 2007 issue of *The Corporate Counsel*, we follow up on 1933 Act registration aspects of Google's TSO program.

ESOARS—Staff Reaffirms Use to Value Options Under 123(R) (But, Other Accounting Uncertainties)

Our readers will recall our feature discussion of the Staff's blessing of Zions Bancorp's ESOARS (Employee Stock Option Appreciation Rights Securities) tracking security (in our May-June 2007 issue at pg 1). On October 17, the Staff essentially affirmed its position in the context of Zions' May 2007 auction experience. It's time for an update.

ESOARS are intended to create a "comparable" for valuing the underlying stock options that the ESOARS "track." As we discussed, the Staff so far has rejected the non-tracking approach to market-based valuation, *i.e.*, creating a market for an instrument that actually mirrors the terms and conditions of employee stock options, *e.g.*, Cisco's 2005 proposal to the Staff (see our September-October 2006 issue at pg 10).The Staff rejected that approach because of perceived difficulties in replicating the employer-employee relationship in the issuer-investor context.

The Staff says that "because investors wouldn't be able to trade or hedge the Cisco options (that, e.g., are subject to all restrictions applicable to the equivalent employee options, including forfeiture), the market price of the options would tend to depart from (i.e., be less than) fair value; an August 31, 2005 memo from the SEC's Office of Economic Analysis to the SEC's Chief Accountant quoted a study showing non-traded options priced 21% lower than traded options (the Staff didn't believe these restrictions would cause investors to exercise in a manner similar to employees, because of basic differences inherent to employee and investor populations, e.g., (i) the two have different risk tolerance, (ii) employees earn their options through service whereas investors pay cash for their options, (iii) employees can contribute to the growth and performance of the company, and (iv) employees' livelihoods are more directly dependent on the performance of the company" and because there have been no actual sales of any such instruments that would establish a price that the SEC could use to validate the approach. (One of the reasons Zions held a beta auction in June 2006 without planning to actually use the value established by that auction was to demonstrate the feasibility of ESOARS.)

Zions' May 2007 ESOARS Auction

As we discussed, Zions' program entails a public auction (via the Internet) simultaneous with the grant of the stock options being valued. Zions intends to limit itself to infrequent grant dates, possibly just a single annual grant date. Isolated mid-year grants would be valued by Zions selecting either (i) the auction discount (e.g., 14%) might be applied to Black-Scholes, or (ii) the implied volatility derived from the auction (e.g., 15% for Zions' recent auction) could be used for Black-Scholes, instead of historical volatility (18% for Zions in 2006)—see our March-April 2007 issue at pg 1. Auditors haven't yet signed off on (i) or (ii), but (ii) would seem to have a better chance than (i).

Zions auctioned 99,418 ESOARS on May 4, coincident with its annual option grants totaling 994,180 shares (the one-for-ten ratio we discussed). Zions registered the auction sales on SEC Form S-3ASR, which is automatically effective upon filing; thus, the process is facilitated for the largest companies, that qualify as "Well-Known Seasoned Issuers" eligible to use S-3ASR. For each auction, WKSIs need only file with the SEC an immediately effective supplement and any "free-writing" prospectuses. Non-WKSIs might choose to go the less public route of a Rule 144A or a Reg D offering (but, the Staff could have concerns whether such a limited auction reflects market value).

In the Stockholders' Equity footnote and in the MD&A to its June 30 Form 10-Q (same language in both places), Zions disclosed a fair value of $12.06 per share for its May 4 at-the-market option grants at $83.25 per share, resulting from the ESOARS auction. Zions discloses that $12.06 is approximately 14% below the value derived using Black-Scholes.

Zions received approval from the SEC to use the May 4 auction price as the fair value of the options granted on that date (the letter of Conrad Hewitt, SEC Chief Accountant, dated October 17, is available on Naspp.com and sec.gov). Zions should now be able to use ESOARS to value future grants without seeking further approval from the SEC, although the October 17 letter cautions that each auction must be evaluated on its own (presumably, by management and the audit committee and, ultimately, the auditor). In particular, Zions will need to establish that each auction has sufficient sophisticated bidders, that those bidders have sufficient information about the ESOARS and underlying employee stock options, that the bidding pattern reflects an active market, and that bidders are not unduly influenced by the costs of holding, hedging or trading the ESOARS.

There were 43 bidders in Zions' May auction (vs. 57 in its June 2006 auction, but that decline likely was related to a change in procedure that eliminated a 2006 requirement to place a bid in order to see the current clearing price), who submitted a total of 874 bids; only 21 were winning bidders (12 were institutional investors). Based on that, it seems that the threshold for a sufficient number of (sophisticated) bidders is relatively low. The bid prices ranged from as low as $.04 for just one ESOARS unit (although another participant bid $.05 per unit for all 99,418 ESOARS) to $40 per unit for 12 ESOARS. Most of the winning bidders entered the auction at or above a bid of $7.57 (only three of the winning bidders, *i.e.,* those who ended up bidding $12.06 or more, entered the auction below $7.57). Many of the bidders that entered the auction at very low prices (*e.g.*, below $2.00 per unit) never increased their bid above $5.00.

Tweak for Non-Impact of Forfeitures. Zions uses a formula to adjust the ESOARS payout so that forfeitures (as a result of employee terminations prior to vesting) don't reduce the value that investors are willing to pay for ESOARS. Assume that 100,000 ESOARS are issued (tracking underlying employee options on 1,000,000 shares). If 12% of the options are forfeited and the remaining payout is at a gain of $1.00 per share, there is a total gain of $880,000 to the ESOARS (88,000 ESOARS times $10).

But, if none of the options had been forfeited, ESOARS holders would have received $1,000,000. In order to negate the impact of the forfeitures, the ESOARS holders would receive $1.14 ($1,000,000 ÷ $880,000) for every $1 of gain on the options, *i.e.,* $1,000,000 (880,000 x $1.14).

Originally, Zions had proposed to gross up forfeitures based on the initial estimated forfeiture rate, then dividing by actual forfeitures. In our March-April 2007 issue (at pg 3) we suggested that this was overly complicated and didn't fully eliminate forfeitures as a consideration in the valuation; apparently, Zions came to the same conclusion, because they have gone with the above simpler approach. Now, investors

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don't need to think at all about forfeitures. [Zions also considered simply refunding to ESOARS holders the amount they paid for any ESOARS on options that are ultimately forfeited, but didn't do so, apparently because of concern that this approach would tend to reduce value (in that a portion of the investment in ESOARS would earn nothing).]

Dutch Auction. As we discussed, pricing is derived via a "dutch" auction. Because bidders are not able to exert any downward influence on the ultimate price, if a bidder submits a lowball price, that bid simply is not part of the higher bids that result in sale of all the ESOARS being offered. In a typical non-dutch auction, on the other hand, a lowball bid can lead to lower bids in general.

Two-Minute Extension. Zions also injected a two-minute rule, to counter the defect in, e.g., the eBay auction process, where the serious bids generally come in at the last moment, leaving bidders no opportunity to respond/go higher; Zions' auction continues in effect indefinitely until two minutes after the last bid.

The Need for "Due Diligence"

A company shouldn't undertake the ESOARS route without first determining upfront that the auction price will likely result in a valuation sufficiently lower than Black-Scholes, etc. to justify the additional effort and expense. The company's auditors will be involved in overseeing that the auction process will survive scrutiny, and it won't be possible to disregard the auction result after the fact.

An example of when ESOARS can be expected to result in lower valuation is where the marketplace might significantly depart from a valuation assumption dictated by Black-Scholes. Thus, as we have discussed (see our March-April 2007 issue at pg 5), volatility must be measured over the entire expected term, but the company may have changed drastically by acquisition, etc. in the last few years (which the market would be free to recognize, and which already may be recognized by the market for call options on the company's stock). Ditto, an event may have occurred recently that is likely to cause options to be exercised sooner than in the past (*e.g.*, a significant increase in the price of the company's stock). Black-Scholes primarily looks at history, not at the company's current assessment.

Accounting for ESOARS—Still, the Sinker (For Now)

Two general reasons come to mind why ESOARS aren't taking hold (yet): the effort and cost of establishing and administering ESOARS and the marketplace's apparent willingness (to date) to largely disregard the non-cash 123(R) expense that ESOARS are designed to reduce (see pg 11). Opposition to ESOARS by the Council of Institutional Investors and others may also be a factor here.

But, the elephant in this closet clearly is uncertainty over whether ESOARS are "equity" on the company's balance sheet, or a "liability" with variable-type earnings charges as the company's stock price increases and the potential payout increases (see our May-June 2007 issue at pg 4). ESOARS represent a promise by the company, *i.e.*, an obligation, to pay (quarterly) cash or stock to the holders equal to 10% of the aggregate gain on exercises of any of the employee stock options that were granted on the date the ESOARS were auctioned.

FAS 133. Whether the obligation is a liability or equity (akin to preferred stock) is not governed by 123(R), because ESOARS are not a form of stock compensation, but rather a capital raising vehicle. So are subject to a whole host of other accounting standards, including FAS 133, "Accounting for Derivative Instruments and Hedging Activities." FAS 133 is so complicated an entire section of FASB's website is devoted to issues that have arisen during its implementation. (133 is actually noted in the site's navigation panel (no other accounting standard is listed there).) If not equity, ESOARS would show as a liability on the balance sheet that must be revalued at the end of each accounting period and any increase in potential payout since the prior period-end would be an earnings charge (akin to the charge today for, e.g., a cash SAR).

ESOARS' Ratio Might Mitigate Liability Outcome. Doing the math, however, may show that some companies could tolerate liability accounting, especially when only one ESOARS is issued per ten options. Thus, the earnings charge for Zions' May grants totaling approximately 1,000,000 shares is reduced upfront by approximately $2,000,000. The liability "expense" for ESOARS wouldn't reach $2,000,000 (*i.e.*, breakeven) until the stock price increased to $103.10

per share (from the grant price of $83.25), a not completely unhappy scenario. Moreover, a large company that grants large quantities of stock options (*e.g.,* Cisco) may be able to convince the Staff that ESOARS for, say, five percent of the option grants is sufficient to support a true auction. For Zions' 2007 grants, going to five percent would increase the break-even stock price to $123.25!

Payout in Stock. Zions has the right to pay out its ESOARS in its stock rather than cash. Payout in stock is the crux of their argument to the SEC that ESOARS should receive equity treatment. Paying out in stock also would alleviate cash outflow considerations for some companies, although neither introduces concerns over dilution; while full value would be received for the shares (i.e., the cash not paid out), there might well be concerns that the grant of employee stock options inevitably involves the issuance of additional shares to cover ESOARS payouts.

FASB Deliberations. FASB's Emerging Issues Task Force took up the equity vs. liability issue at its September 11, 2007 meeting. (Our readers may recall hearing often about the EITF in the APB No. 25 days; rumors that the EITF was being disbanded after 123(R) was adopted obviously were false.)

The EITF ended up tabling the matter for now. That may end up stalling other companies' plans to pursue ESOARS for now. In its June 30 Form 10-Q, Zions says it is recording its estimated future ESOARS payout obligation as a liability on its balance sheet. Some large companies may become comfortable with liability treatment if based on an amount. Immateriality, at least until several ESOARS tranches have been issued and the numbers begin to add up. It will be interesting to see Zions' ongoing treatment of this issue in its MD&A, etc.

Zions isn't concerned with the "liability" amount for its own financial statements, but Zions' main interest in the ESOARS concept is the potential it brings to its investment banking business, *i.e.,* to guide clients in implementing the program. Zions is presenting its case at the November 29 EITF meeting.

Takis Makridis, a 123(R) guru who heads Equity Methods in Phoenix (so, too, may have an agenda), comes out on the equity side ("When the stock price goes up, ESOARS holders benefit.").

Other Considerations

Even if equity accounting ultimately prevails, there are other potential roadblocks (in addition to the SEC objections). A company's stock should be among the most actively traded, in order for there to be competitive bidding for the ESOARS. It also helps if there already are exchange-traded, standardized options for the company's stock (or convertible debt), which not only provide a reference for potential ESOARS bidders but indicate sufficient market interest for the company's stock to ensure there will be enough bidders in the auction—an important concern mentioned in the SEC's approval. (An ESOARS investment is a bet on the company's stock.)

ESOARS might impact the value that employees perceive they are receiving when granted an option. While less than Black-Scholes value, employees are more likely to relate to an actual auction price as being real. Thus, a Zions employee's receipt of an option in May for 1,000 shares may feel like $12,000 of value.

For many companies, however, ESOARS won't be worth the trouble to save a smallish percentage of 123(R) charges that the marketplace often seems willing to disregard in any event. Stay tuned.

The New Requirement to File a Section 6039 Return with the IRS—For 2007?

As our readers may recall, Code Section 6039 requires companies to provide a report to employees of their ISO and ESPP transactions. (See our November-December 2005 issue at pg 11.) The deadline for furnishing a report to employees is January 31 of the year following the transaction(s) being reported (the same as the W-2 deadline). For ISOs, the reporting requirement is triggered by exercises (to enable AMT computation), and generally is satisfied via a statement of exercise sent at the time of exercise; for ESPPs, it is triggered by the first transfer of ESPP shares by the employee (*e.g.,* upon sale of the shares or even a mere transfer out of a broker's account triggers reporting, even if only to another broker—see our September-October 2000 issue at pg 5).

Up until now, the sole purpose behind Section 6039 reporting has been to provide employees with information they may need to file their income tax return. Now, however, Congress apparently wants companies to also provide the

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information to the IRS as a means to facilitate tax audits. Under the Tax Relief and Health Care Act of 2006, companies are required to file a §6039 "return" with the IRS, effective for transactions occurring on or after January 1, 2007. Presumably, the filing deadline here will be the end of February (March, if filed electronically), the same as the deadline for filing W-2 copies with the IRS.

A Reprieve For Now (and Maybe Longer)?

Despite Congress's intentions, however, it doesn't look like this requirement will really go into effect in time for 2007 transactions. The IRS has yet to issue any regulations or other guidance specifying how, when or what to file. As amended, §6039 requires companies to file a return *as prescribed by the Secretary*. Thus, until regulations are issued, there is no requirement to file a §6039 return with the IRS. This project is not listed in the IRS priority plan for guidance in 2007 and 2008, and a representative we spoke with at the IRS said that it doesn't appear to be on the radar at all. Thus, it could be several years before companies are required to file annual §6039 returns with the IRS.

Does Anyone Really Care About the FAS 123(R) Earnings Charge?— Deep Thoughts II (and Some Shallow Ones, Too)

One buzz we took away from the NASPP Conference is that January 1, 2005 (*i.e.*, the advent of mandatory expensing of stock options) essentially may be ending up like Y2K, *i.e.*, a non-event. Where a company's 123(R) charge is high (*i.e.*, a material amount), analysts, etc. routinely back it out of their analysis. Where the amount is immaterial (*e.g.*, at large companies like General Electric), no one even bothers to back out (or look at) the 123(R) charge.

This doesn't mean that companies are disregarding 123(R), however, in their grant practices. While only a few may be sensitive to the earnings impact, Peter [illegible] of FAS123 Solutions points out that companies (and their investors) do pay attention to 123(R) charges for corporate governance, etc., reasons, *e.g.*, (i) for determining the size of grants, (ii) as a measure of the shareholder value transferred to employees, and of the relationship of cash and equity compensation, (iii) for comparison with the value perceived to be received by employees, and (iv) for assessing whether the company is receiving a commensurate return on the value it is paying. Moreover, 123(R) charges help companies in allocating their equity compensation among the various equity-grant types, *e.g.*, options, restricted stock, and performance awards.

Restricted Stock, Too?

The sub-buzz here is that 123(R) charges are largely disregarded because, even though recurring, they are a non-cash expense. But, is that reasoning also being applied to restricted stock?

As mandatory expensing approached, we had wondered whether under 123(R) restricted stock expense (which was fully applicable pre-123(R), and even pre-FAS 123, and wasn't generally questioned) would end up being bundled with stock options (and disregarded). (See our May-June 2006 issue at pg. 10.) That actually may be occurring now.

We are not particularly sanguine with analysts, etc. ignoring restricted stock expense. Moreover, does this mean that companies that granted restricted stock pre-123(R) now get a bump up because, post-123(R), that expense is being backed out? What if companies were to begin granting large amounts of unrestricted (*i.e.*, bonus) stock? That's non-cash, too! Fortunately, the governance concerns discussed above are relevant here, too.

Even *cash* 123(R) expense, *e.g.*, from liability awards such as cash SARs or where there is excess tax withholding on stock option exercises, might get bundled in here.

Going Green with 123(R)?

On a less deep front, we're considering dropping the parens from 123(R), going instead with "123R." We've often wondered why FASB went with the parens, which just use countless extra keystrokes, ink and paper, and (for those of us dinosaurs that insist on handwriting our first drafts) even handstrokes, to say nothing of typo corrections. We'd like to hear from readers on this one. We promise not to shorten our issue length by the space we would save.

RiskMetrics, Too. While on the subject of dusting names, we're planning to stick with the pre-acquisition old name here, ISS, that we all know (and love/hate, etc.). This one's not for saving strokes, etc., but for familiarity. Moreover, a close look reveals "ISS" is still accurate, in that ISS Governance Services is identified as a distinct division on the letterhead of the RiskMetrics Group.

The New Rule 144 Amendments—Our Upcoming Video Conference

In response to many requests from readers who are coming to recognize that the SEC's major changes to Rule 144 will open up many new compliance and preventive obligations and problems—particularly for issuers and brokers—we have decided to host a major Video Conference. The Conference will take place on January 15th, in time for issuers and brokers to then use our model forms and procedures to prepare all the necessary new procedures, memos, forms, representation letters, legends etc. that will be called for.

The Video Conference will be "a must" for every public company and every brokerage firm (and all law firms that advise issuers and brokers). See the enclosed for more information—or go to TheCorporateCounsel.net to register today. (Note the significantly reduced costs for 2008 subscribers.)

Model CD&A Language—Renew Now

To assist our readers in putting the Staff's CD&A guidance into practice, we are accelerating the next issue of *The Corporate Executive*, where we are providing examples of model analysis language to illustrate what the Staff will now be looking for in the CD&A.

To get these examples into readers' hands now—as you begin to prepare your CD&As—we are posting an Advance Copy of the January-February issue during the first week of December. The issue can be accessed by all 2008 subscribers to *The Corporate Executive* by going to the home page of TheCorporateCounsel.net and then clicking on the prominent link to the issue. You will need to renew your subscription—and have your 5-digit code from your mailing label and your zip code—in order to access this important issue.

Critical January Webconference: "*The Latest Developments:* Your Upcoming Proxy Disclosures—What You Need to Do Now!"

On CompensationStandards.com, do not miss the two-part webconference—featuring David Lynn, Mark Borges, Ron Mueller and Alan Dye that will provide you with all the latest guidance on your upcoming disclosures in response to the SEC's *very latest positions and expectations*—including what you should be doing now in some of the most sensitive areas.

These webcasts will provide an important follow-up from our blockbuster October Conference as we get into the proxy season, updating us all. Renew your CompensationStandards.com membership (or enter a no-risk trial) to ensure your disclosures meet the Staff's latest expectations.

And Much More: As all of our print subscriptions and website memberships are on a calendar year basis, it is time for you to renew (either use the enclosed renewal form or go to TheCorporateCounsel.net's "Renewal Center" or take advantage of a no-risk trial on the "No-Risk Trial Center" on that site).

Here are some important upcoming webcasts:

– TheCorporateCounsel.net's "Rightsizing Compliance Programs for Smaller Companies" (12/4)

– DealLawyers.com's "The Latest on Fairness Opinions" (12/6)

– *The Corporate Counsel*'s & TheCorporateCounsel.net's "New Rule 144—What to Do Now" (1/15)

– DealLawyers.com's "The 'Former' SEC Staff Speaks" (1/16)

– TheCorporateCounsel.net's "Forecast for 2008 Proxy Season: Wild and Wooly" (1/22)

– CompensationStandards.com's "Part I: *The Latest Developments:* Your Upcoming Proxy Disclosures—What You Need to Do Now!" (1/23)

– CompensationStandards.com's "Part II: *The Latest Developments:* Your Upcoming Proxy Disclosures—What You Need to Do Now!" (1/31)

– Section16.net's and Naspp.com's "Alan Dye: Keeping Yourself Out of Section 16 'Hot Water'" (1/29)

– TheCorporateCounsel.net's "The Former SEC Staff Speaks" (2/6)

—JMB/MG

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