Bank's auction plan could cut companies' charges for options

SILICON VALLEY AND BEYOND WATCHING CLOSELY

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An innovative auction by a Utah-based bank could spark a revolution in the way tech companies handle the accounting hit from stock options, the subject of perhaps the most bitter and passionately fought political debate in Silicon Valley's history.

Starting today through Monday, Zions Bancorp will let investors bid on an investment that will give them a chance to profit when workers cash in their stock options.

Silicon Valley companies are watching the auction closely because it could help them whittle down the accounting charges for their own options, and thus increase their profits.

If the controversial experiment works - and regulators support it - it could also encourage companies to loosen the spigot on options for rank-and-file workers.

All of this hinges on the expectation that bidders will pay significantly less for this novel investment than the theoretical price tag for options derived from the Nobel Prize-winning Black-Scholes formula, the most widely used measure now. Critics say Black-Scholes significantly inflates the cost of options.

If the auction trims the accounting charge, Zions Bank Vice President Evan Hill hopes others will sign up for its program. About 50 large companies from the valley and across the country have requested access so they can monitor the auction.

"We have a lot of interest that is contingent on our successfully being the guinea pig," Hill said. The companies are saying, "Show us the number" that can be used for accounting purposes "and we will follow your approach."

The auction also will be studied by investors who lobbied for more than a decade to force companies to expense stock options.

`Fair value' question

"The open question is whether this auction process results in a real fair value," said Jeff Mahoney, general counsel for the Council of Institutional Investors, which represents 140 public, private and corporate pension funds that invest more than $3 trillion. Mahoney is scheduled to meet with Securities and Exchange Commission officials to discuss whether Zions' auction was constructed and marketed adequately to produce a reliable number for accounting purposes.

To appreciate why so many eyes in Silicon Valley are on Zions' experiment, it helps to recall the decade-long war that tech companies fought over the accounting rules for stock options.

One symbolic highlight was the 1994 "Rally in the Valley," when about 3,000 workers and a 55-piece marching band crammed into the San Jose Convention Center. One of the lustiest cheers came when Cypress Semiconductor boss T.J. Rodgers roared that the rule-making "commissars" were "suffering from rectal-cranial insertion."

Silicon Valley ultimately lost the war. Starting in their 2006 fiscal year, companies were required to subtract the cost of stock options from profits - erasing billions from their bottom lines.

Companies have tried a number of controversial tactics to trim that cost. Most have slowed the flow of options to workers. And many companies raised eyebrows by tinkering with the numbers they plug into the Black-Scholes formula so that a lower total will spit out.

"If someone were to ask me what the next big scandal will be for stock options after we get past backdating, I would say the subjective valuing of options is ripe," said Barbara Baksa, executive director of the National Association of Stock Plan Professionals. "There's a lot of subjectivity, a lot of manipulation and a lot of motivation for companies to manipulate these numbers."

Regulators, accounting rule-makers and institutional investors generally support the idea of letting actual investors put a price on stock options. The daunting task is how to do that in a way that results in a reliable number for accounting purposes.

That's not stopping people from trying, though.

Cisco's `derivative'

In 2005, the Securities and Exchange Commission deflected Cisco Systems' idea to create a "derivative" investment designed to mimic its employee stock options. Bear Stearns and Citigroup developed blueprints for other methods.

"I'll wager we'll see a lot more things of this level of creativity over the next year or so," said Ted Buyniski, a compensation consultant with Radford Surveys \+ Consulting.

Zions' proposal is the first to get this far. Last year, Zions tested its idea with a similar auction of "Employee Stock Option Appreciation Rights Securities," or ESOARS, but the SEC wouldn't allow the bids to be used for accounting purposes because of technical problems. The agency also warned that Zions could run into resistance if its accounting number substantially undercut the Black-Scholes valuation.

Hill is confident that Zions has worked out the technical bugs. If Zions is right, it hopes to conduct similar auctions through its brokerage arm for other companies and become the "eBay of ESOARS," as Hill puts it.

Experts predict Zions' experiment could open the door for others to roll out competing methods.

"Ultimately, this could change how we value employee stock options," said Baksa of the NASPP. "We're clearly a long way from that, but it could be a landmark development."