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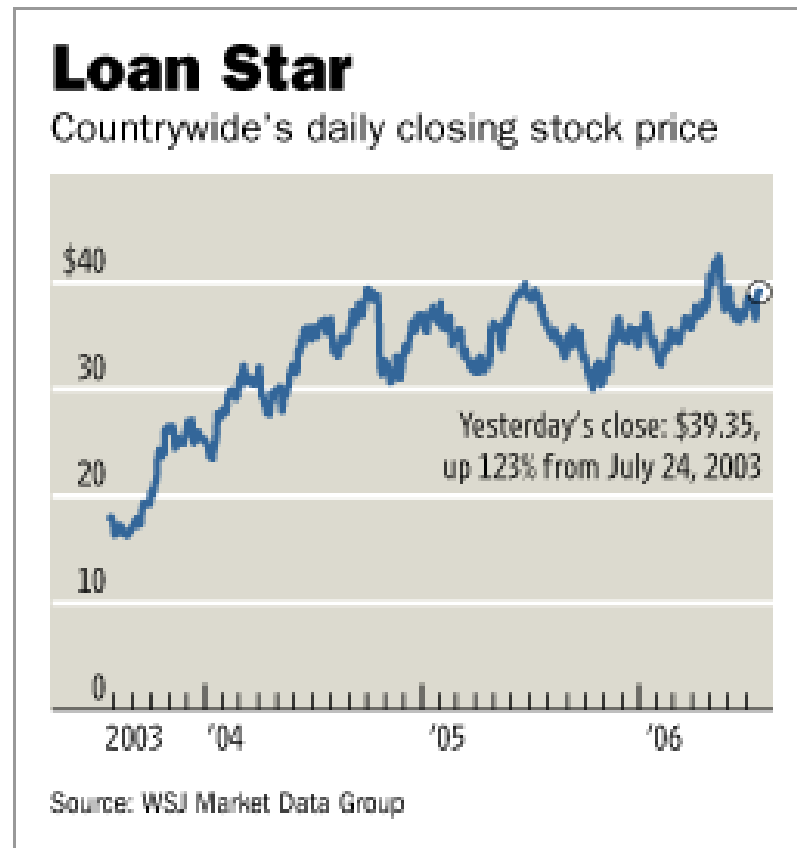
How to Value Stock Options? Bear Stearns Weighs In

By David Reilly

July 26, 2006 12:01 am ET

Another contestant has joined the race to build a better mouse trap for valuing employee stock options.

Analysts at Wall Street's Bear Stearns Cos. have outlined a proposal for competitive pricing of employee stock options that they claim would be a better gauge of value than the models companies currently use. The idea, laid out in a recent report, calls for companies to sell 10-year options to investors to be traded alongside the stock options they grant employees.



Then, once an employee gains the right to exercise the options, or vests in them, they would trade alongside the existing market-traded instruments. As they exist today, employee stock options aren't tradable. An added benefit: being able to trade employee stock options could make them more valuable, so companies could issue fewer options and still generate the same amount of compensation for employees, said Dane Mott, a Bear Stearns accounting analyst.

Bear Stearns also proposes allowing employees to take some of their options grant in the form of a debt instrument that would guarantee some return, whereas stock options either become profitable or expire worthless.

Employee stock options currently aren't traded, so companies use various models to value them. But executives complain these models are really designed to value exchange-traded options, not employee stock options, so the models overstate the employee stock options' value and thus lead to a bigger-than-needed hit to profits.

There are hurdles to the Bear Stearns idea, however. Exchange-listed options (which are sold by third parties, not the companies whose stock they track) have very short lives, usually only a few months each. Creating marketable securities based on long-term employee stock options would require investors to grapple with many uncertainties.

"In the options world, 10 years is a very long time," said Stacey Briere Gilbert, chief options strategist at Susquehanna Financial Group. Investors who typically trade options would have a hard time measuring the volatility -- or the amount of change in a share price -- in the long-term employee stock options, Ms. Briere Gilbert pointed out. Volatility is a key component of options trading. Fluctuations in interest rates would also be a greater risk over a 10-year period.

"I don't think there's going to be a whole lot of interest in trading long-term options on individual stocks," added Robert Whaley, a finance professor at Vanderbilt University.

Still, Prof. Whaley said Bear's idea could be worth exploring given companies' interest in coming up with new options-valuation approaches. Several companies tried last year to come up with their own market-based valuation methods. The Securities and Exchange Commission shot down their efforts, saying the approaches didn't create actual market values.

Here are the details of the Bear plan: Say a company wants to issue 10 million stock options. It would first give employees the choice of taking their grant as a mixture of options and a debt instrument that would have a guaranteed payout. This would allow an employee to have the upside that can come from stock options, while also guaranteeing that they will see some money if the firm's stock tanks.

Assume that the employees decide to take 65% of their grant as options and the remainder as bond units. The company would then take the 3.5 million options employees didn't take up and sell those in an auction. The premium generated from this sale would determine the market value of the options and be used to determine the expense the company should book. The premium income would also be used to fund the bond units, which would be invested in short-term, high-grade debt.

Those employees who do choose to exercise their options after a four-year vesting period would have options that are the same as the existing, market-traded options, which would remain outstanding for an additional six years. At this point, the bond units would also have vested and employees would receive the principal and interest generated as a cash payment.

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