

June 14, 2004

Letter of Comment No: 3633
File Reference: 1102-100

Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

RE: Share-Based Payment: An Amendment of FASB Statements No. 123 and 95.
Comments Related to ESPPs (File Reference No. 1102-100)

myStockOptions.com is the premier provider of web-based educational content and tools on stock options, restricted stock, and employee share purchase plans (ESPPs). We have a popular public site for plan participants and offer services for companies, stock plan services providers, and financial institutions.

Our comment letter has two purposes: (1) to provide comments that FASB requested about Issue No. 6 on ESPPs in its most current Exposure Draft; and (2) to present FASB with alternative thinking on its approach to ESPPs.

When Are ESPPs Compensatory?

Issue No. 6 asks:

"[T]his proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of shares. Do you agree with that principle? If not, why not?"

This draft changes the approach under Statement No. 123. When the ESPP has no more than a 5% discount and no look-back feature, the pre-amended rules do not consider it compensatory, and no expensing is required. Even after understanding FASB's concern that certain types of ESPPs have stock-option-like characteristics, this change is too extreme and goes beyond the logic of what you are trying to do with the amendments.

FASB expresses its concern that ESPPs with look-back features are just another form of "stock option." You demonstrate this by labeling these ESPPs "Look-Back Share Options" in Illustration 18 of Appendix B (Paragraphs B168-B176). However, in Paragraph C77 you then lump together all ESPPs as compensation, when in fact they have great variety.

Many ESPPs are true "stock purchase plans" that are not compensatory or similar to stock-based payments at all. ESPPs funded with employee salary contributions (after tax) over a six-month period with discounts only on the actual market price at purchase are true "stock purchase plans." They are not "share-based payments," "stock options," or "stock awards."

Nowhere in the Exposure Draft do you recognize that with most ESPPs, employees lock up money from their paychecks—with no interest—for six months before the purchase. The 5% discount on the purchase date (or perhaps at least allowing a discount no greater than a selected financial measure, such as the 10-year T-Bill rate) seems a reasonable, noncompensatory arrangement in exchange for the lock-up of employees' cash over the six-month period of salary deductions. Plus, with some stock purchase plans, the shares are not transferred into the employees' accounts until after the ESPP purchase date, so employees face additional market risk.

Most stock market investors would expect (or at least hope for) greater than a 5% return on shares they purchased over a six-month period, particularly if they had to tie up their after-tax investment money without interest for six months. Therefore, ESPPs with a 5% discount are actually *less* favorable "than those available to all holders of the same class of shares," not *more* favorable. Employees tell myStockOptions.com that they use these types of plans to regularly save money from their paychecks and to purchase company stock by dollar-cost averaging their investment. These types of plans lack any option-like features and are far from being viewed as "compensation."

Companies Sell Stock At Discounts

Companies sell stock to large investors at discounts, even respected public companies, in what are known as PIPEs (private investments in public equity) offerings. (See the article in *BusinessWeek* of May 10, 2004, entitled "A Pipeline to Bargain Deals," available on www.businessweek.com.) Companies are not required to expense this discount on their income statements. A PIPE expert quoted in the article states that "Discounts can range as wide as 50% for weak companies to 5% for strong ones."

If companies do not need to expense this discount on stock sold to investors, why should companies have to expense the discount on stock sold to employees?

In addition, the discount should be larger than 5% before ESPPs shift from being a "benefit" to a compensatory "share-based payment." As the *BusinessWeek* article above reports, quoting another expert, a typical secondary securities offering "takes six months to do and costs at least 10% of the deal's value in underwriting fees plus legal costs and road show expenses." Therefore, a 10% discount before a required accounting expense seems justified compared to other forms of capital raising.

ESPPs Are Not Share-Based Payments Or Stock Options

Paragraph C77 lays out FASB's core reasoning for this change in ESPP accounting from pre-amended Statement No. 123. To justify why companies should expense ESPPs, FASB re-characterizes compensation as anything employees receive from their "employment relationship" that is not made available to other shareholders.

This overly broad effort in Paragraph C77 to redefine all "benefits" as "compensation" results in numerous real-world inconsistencies.

Illustration: Many companies offer their employees discounts on purchasing their products or shopping in their stores. These are "transactions with employees in their roles as employees" (quoting the language in Paragraph C77). An employee of a car company, for example, can buy a car from its employer at a discount. The company offers this discount for three reasons (with no accounting charge to the employer for the discount):

1. Provides an employee benefit
2. Wants employees owning its product
3. Generates revenue from sales

Companies offer ESPPs for the same reasons (but with a proposed accounting charge):

1. Provides an employee benefit
2. Wants employees owning and holding its stock
3. Generates cash from sales

We have not seen a survey that asks employees to score a series of company-provided "goodies" (e.g., health insurance, 401(k)s, stock options, life insurance, ESPPs, massage) as either a "benefit" or "compensation." However, based on our experience at myStockOptions.com in interacting directly with ESPP participants, we think they would overwhelmingly view ESPPs as a benefit. In addition, from our experience in working directly with companies and stock plan providers, we see that a substantial number of companies treat the administration of ESPPs as the responsibility of the benefits department, not part of compensation planning, design, or administration.

Even the terminology for ESPPs is different than that for share-based payments such as stock options. With ESPPs you "enroll" and have "payroll deductions," concepts and procedures completely different than those of stock options or any type of compensation.

These distinctions between ESPPs and share-based payments have not been lost on other respected organizations and agencies that have studied them and developed their own rules for valuation, shareholder voting requirements for plan modifications, and disclosure. We suggest you speak with Institutional Shareholder Services (ISS), the NYSE and NASDAQ, and the SEC about how they treat ESPPs differently than stock options.

A bright line is hard to draw between "benefit" and "compensation." However, FASB's current approach is more like "I know it when I see it," paraphrasing a U.S. Supreme Court Justice's often-quoted approach to defining pornography. FASB sees all ESPPs as a form of "share option" or "share-based payment," without attempting to recognize the real differences.

Recommendations

As FASB's Exposure Draft has evolved to more accurately understand the unique features of employee stock options, applying it to ESPPs has become more of a logical stretch. We recommend that FASB consider the following:

1. Create a committee devoted to ESPPs, similar in concept to the Option Valuation Group (OVG).
2. This ESPP group would take the same in-depth approach to ESPPs that the OVG undertook in developing its position on lattice-based models.
3. The ESPP group would be devoted to accurately determining when an ESPP is a noncompensatory "benefit" and when it is "share-based compensation," and to analyzing whether and how stock option valuation models can better fit ESPPs to determine their "fair value."
4. Propose a separate Statement of Financial Accounting Standards on ESPPs that recognizes the differences between ESPPs and share-based payments and between different types of ESPPs, and evaluates changes in valuation models for ESPPs.
5. In the interim, companies can continue footnote disclosure for ESPPs under APB No. 25. This would also give companies more time to become familiar with FASB's newly favored but complex lattice-based stock option valuation models before applying them to ESPPs.

Sincerely yours,

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cc: Mr. Michael W. Tovey