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SECURITIES LITIGATION & CONSULTING GROUP

Out-of-Pocket Losses in Exercise and Hold Stock Options Arbitrations

Introduction

Out-of-pocket profit or loss is often the starting point when evaluating a brokerage account's returns. Out-of-pocket profit or loss is the change in an account's value plus the value of cash and securities withdrawn less the value of cash and securities deposited.

Respondents and Claimants both use closing stock prices on the dates securities are received or delivered to calculate out-of-pocket losses.

To fairly evaluate an account's out-of-pocket loss, Respondents must not be credited for an increase in value of the Claimant's assets – or charged with a decline in value of the Claimant's assets – which were not under the Respondent's supervision, control or influence during the relevant time period.

Stock Option Arbitrations

This widely acknowledged principle for calculating out-of-pocket losses is routinely violated in securities arbitrations involving employee stock options, when Respondents value stock received into an account at the options' strike price. Respondents justify valuing the received shares at the strike price by arguing that this is all the customer "paid" for the shares received into the account.

Employees surrender contractual rights under their option contracts along with the cash strike price when they exercise stock options. These rights are worth at least the excess of the stock's current market price over the strike price of the option. Thus, employees tender consideration equal to - and therefore pay - the full value of the shares they receive.

Respondents also argue that the strike price should be used since it is the cost basis of shares acquired from exercising incentive stock options ("ISOs") if the shares are held for a year. The closing stock price when the option is exercised – not the strike price – is the cost basis of shares acquired from exercising non-qualified options and the special tax treatment of ISOs does not justify a different valuation on the shares received.

Moreover, Respondents only advance this IRS-based justification in options cases since in many other cases it would allow Claimants to claim unrealized losses incurred before assets transferred into a brokerage firm.

Employee Options Are Compensation and They Earn Investment Returns

Employees receive stock options from employers as part of their compensation. In fact, the SEC requires that firms disclose the value of stock options on the date they are granted because they are compensation expense.

As with traded options, the value of employee stock options varies after the options are granted with changes in the price and volatility of the employer's stock, changes in the risk free interest rate and with the passage of time. The change in the options' value is an investment return on assets which may not be under the Respondents' supervision, control or influence.

Conclusion

The value of contractual rights employees surrender when they exercise employee options is equal to the option's value when they were initially granted (which was compensation in lieu of cash) plus any change in the option value between when the option was granted and when it was exercised (which was subsequent investment returns).

The use of strike prices to value shares received into an account is therefore equivalent to offsetting losses incurred in the account with compensation the customer received from their employer and with investment returns earned on assets which were not under the Respondent's supervision, control or influence.

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 SLCG Practice Notes are intended to deal briefly with narrow topics. This note does not address unexercised options or assets held at other firms in reliance on or influenced by Respondents. More substantial working papers, including two dealing with employee stock option arbitrations are available at www.slcg.com. Craig McCann, PhD, CFA craigmccann@slcg.com, 703-246-9381; Dengpan Luo, PhD, dengpanluo@slcg.com, 703-246-9382.