**NewsHour with Jim Lehrer, July 20, 2003, with Robert C. Merton on Stock Options**

PAUL SOLMAN: Stock options: They helped fuel the high-flying, high-tech market of the 1990s. But since its fall, they’ve become controversial. So this week, when giant Microsoft announced it would stop awarding stock options to employees, and would change its accounting for them in past years, it was big news in corporate America.

But before we discuss it, we take you back several years to the first few minutes of a report we did on options in their heyday.

PAUL SOLMAN: At San Francisco airport, Silicon Valley salesman Jason Beacon about to meet in an executive lounge with two of California’s hottest high-tech headhunters, who let us sit in on the meeting.

SPOKESMAN: Let’s talk about money. Last year, 1999, your W-2 was?

JASON BEACON: 230.

SPOKESMAN: 230. Where do you think you’ll end up this year?

JASON BEACON: I’m really shooting for probably upwards of 300, on up. So, I kind of set the benchmark this year, so I’m looking to kind of take it up a notch next year.

SPOKESMAN: Keep raising the bar.

JASON BEACON: Definitely.

SPOKESMAN: Perfect.

PAUL SOLMAN: Bob Silver and Howard Lee had been hired by a bay area startup planning an IPO, an Initial Public Offering of its stock on the open market. The main pitch to 30-year-old Jason: a pay package including options to buy that stock for a song.

SPOKESMAN: And we’re talking about something in the neighborhood of 15,000 shares of pre-IPO stock, somewhere in the $2 range, as a price of options. And, of course, it’s too early to tell where our company’s going to be when they IPO, okay? But if all we did was compare them…

PAUL SOLMAN: In short, if this new company does as well as some similar startups, Jason’s 15,000 shares, $2 a share, would be worth more than $2 million; the difference between the option price and the expected market price. Jason will have to wait a while, because options to buy stock at an artificially low price can’t be exercised and cashed in right away, but eventually, he figures, he could be rich.

JASON BEACON: And that’s really what I’m looking for because, you know, a $200,000 to $300,000 a year income is probably great and definitely secure. I think you can all have a great life, but, you know, if we all kind of want to get to the point of retiring early, or earlier, then it just comes down to equity. You got to own something.

PAUL SOLMAN: You got to own; that’s the new mantra of the new economy, which you see in northern California everywhere you look. The dot-coms seem to have taken over here, creating enormous wealth, and stock options have spread that wealth throughout the high-tech labor force.

At the beginning of the 1990’s about a million American workers had stock options in their companies; today the number is nearly 10 million.

The main argument for options is that they motivate employees to work harder, smarter, more efficiently, so as to make their company more valuable, its stock price higher, at which point they can exercise their options at the old low price, re-sell them at the new one, and cash in big-time.

PAUL SOLMAN: Joining me now to bring the story up to date is Robert Merton, who teaches at the Harvard Business School and was awarded the Nobel Prize in economics for a way of setting a price on options. Professor Merton welcome.

PAUL SOLMAN: If options were such a great way to attract top talent, why is Microsoft now stopping giving options?

ROBERT MERTON: Well, Microsoft has the largest employee stock option plan in the world, and its cancellation of that program to replace it with restricted stock as the form of grant attempt to create that same incentive or motivation for employees to help grow the company and the value of the company’s stock.

PAUL SOLMAN: Restricted stock, so this is stock that I get if I’m an employee in one of these companies, instead of the stock option. Restricted, what does that mean?

ROBERT MERTON: Restricted stock is just like the regular stock that we see traded — Microsoft in this case trades on NASDAQ — except that you can’t either buy or sell it, you can’t sell it for a period of time, typically four or five years, and your rights to it, your ownership of it is delayed until the end of what’s called a vesting period in which, again, about four or five years. But after that happens, the stock is yours and you own it just the same as any other investor in the company stock.

PAUL SOLMAN: Okay. So you get stock instead of options, but why not give options any more, I mean, why did they change?

ROBERT MERTON: I think you want to look at it first from the point of view of the employees, and since for the same size grant, a share of stock is worth more than an option on a share of stock —

PAUL SOLMAN: Because it’s going to – you can sell it and…

ROBERT MERTON: …and with the option you actually have to pay something to get stock, whereas when you get the stock you don’t pay anything extra, so the stock sells for more than the option.

PAUL SOLMAN: When you say pay, you mean that’s the exercise price?

ROBERT MERTON: Yes.

PAUL SOLMAN: You pay the price but the stock is higher, you make the difference?

ROBERT MERTON: Exactly.

PAUL SOLMAN: That’s the option. With the stock you’ve just got the stock.

ROBERT MERTON: Exactly.

PAUL SOLMAN: So why stop the option, because the option is getting all these terrifically talented people to these companies?

ROBERT MERTON: Although the amount of option shares you get with a restricted stock, because the stock is worth more, will be fewer than you get with options, it’s also less risky. If you get an option at a particular exercise price, if the stock of the company does not appreciate going forward, at the end of the time when the option expires, you have something that has no value.

PAUL SOLMAN: I see. So if it’s $27 — today is Microsoft’s price — something like that — and the exercise price is 27 bucks and it never goes beyond 27 bucks —

ROBERT MERTON: That’s right. The options will be worthless at the end, whereas, if you’d been given restricted stock, at the end of the restriction period it would be worth whatever Microsoft’s stock is worth, so if it’s still 27 five years from now, your stock would be worth 27.

PAUL SOLMAN: So is that why Microsoft did this because it has all these employees who have options? I read today some people have options at a $119 a share for Microsoft, and it’s at $27, so it’s…God knows how long it will be before it gets to that price, right, if ever, and therefore, they simply don’t get anything, no benefit at all, so is that why they changed?

ROBERT MERTON: It seems that one of the key reasons was they did focus groups and interviews with their employees and talked to them about alternative ways of providing these incentives and the employees truly are very, very unhappy with the decline of the last three years in general in the market, and what we see at Microsoft is repeated over and over again at any number of companies, both high tech and even out of that sector.

And so now employees have learned the down side of having the leverage of option, and when things don’t appreciate, they see their options way underwater, by that I mean selling with an exercise price much higher than the current stock price, and so probably they have no sense of what it’s worth – many of them think it’s worth nothing. And as a result of that experience, they’re quite unhappy.

The feeling here was that by offering them something that’s more tangible in sense of the restricted stock and importantly something where they can see the value of it every day because a stock trades, Microsoft’s stock trades, you can look at it on the screen and say, well, my stock’s worth 27 or 28 or 24, but the options that were granted, of the kind that were granted, are not traded, and so even though they may have value, the employee may not ascribe the appropriate amount of value to it.

PAUL SOLMAN: I took down — Steven Balmer, the CEO of Microsoft, the quote — “And I think it helped with the stability and predictability of the compensation, which actually will be helpful in attracting and retaining personnel.”

So in this environment, as opposed to what we saw in the year 2000, in this environment you want people — they want predictable, they want stable, whereas in the old days they were –

ROBERT MERTON: Yes, it is less risky, but it should be said that while on the down side the restricted stock will be less risky, it’s also true that if Microsoft does very well over the next many years, some people will probably look back and say I wish I’d had the options because clearly with more options or more shares, that the stock would do really very, very well, you would have been better off with the old program.

PAUL SOLMAN: And why did they give less stock than they used to give options. Why will Microsoft be giving less stocks than options?

ROBERT MERTON: Well, because the amount of the grant, the value of what they give employees can’t change that dramatically from what they have done in the past. And if the value of the options is, let’s say, a third or significantly less, than the value of the corresponding number of shares, to give the same value, they have to give shares on a fewer number of restricted stock shares.

PAUL SOLMAN: I see, so it’s just to keep it even. Now Microsoft is also restating its earnings for past years to account for option grants. Why is it doing that?

ROBERT MERTON: It isn’t required to do this, but this is a reflection of a controversy which has been going on now for a good year, and then dates back much earlier in time, over whether options should be expensed or not.

PAUL SOLMAN: That is whether or not they should be deducted from the profits of the company, the value of the options, right?

ROBERT MERTON: That’s right. The value at the time of grant as any other form of compensation, like paying the wages, deducted from earnings as an expense.

PAUL SOLMAN: Something of value, so let’s say that cost us something, therefore, we should deduct it from profits. People weren’t doing that. Microsoft is now going to retroactively.

ROBERT MERTON: Retroactively. The controversy on not doing that, which has been led principally by the high-tech industry, has been dealt a blow with this, I think because in doing this, in Microsoft going back, restating its earnings to reflect what the expensing of those options, in a sense it’s essentially endorsing the expensing of options, and of course Microsoft is a bellwether as the lead firm, the largest certainly in the tech industry, that’s quite significant.

PAUL SOLMAN: Do you think…do you suppose that other companies are now going to follow suit because Microsoft is, as you say, a bellwether?

ROBERT MERTON: I think the pressure will be on them to do that. I think another reason why they may – which was Microsoft I think gave this – was that the valuation of restricted stock, because we can see the value every day in the marketplace, is a lot simpler than valuing the old options, which don’t trade in the marketplace directly. And as a result they may feel that by using restricted stock they’ll have a more accurate estimate in the accounting of the expense of their employee compensation costs.

PAUL SOLMAN: Going forward?

ROBERT MERTON: Going forward.

PAUL SOLMAN: And that’s an appeal for lots of people and certainly in this environment.

ROBERT MERTON: Yes.

PAUL SOLMAN: Well, thank you very much, Professor Merton, nice to see you.

ROBERT MERTON: Okay.