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SEC CONFIRMS ZIONS BANCORPORATION'S ESOARS AND AUCTION PROCESS MEET THE MEASUREMENT OBJECTIVES OF FAS123R FOR DETERMINING ACCOUNTING EXPENSE

The SEC advised Zions Bancorporation in an October 17, 2007 letter from the SEC Chief Accountant that the SEC did not object to the Company's view that its Employee Stock Option Appreciation Rights Securities (ESOARS™) were "sufficiently designed to meet the measurement objective of Statement 123R" and that the market-clearing price of the ESOARS auctioned from May 4-7, 2007 is a "reasonable estimate of the fair value of the underlying employee stock options granted on May 4, 2007."

What are ESOARS?

- ESOARS are investment securities designed to provide a market-based measure of the value of employee stock option grants. ESOARS track the value of a "reference pool" of employee stock options and provide the holder with payments equal to a pro-rata share of the value realized by employees from the exercise of the reference pool of employee stock options.
  - Payments are made to the holders of ESOARS quarterly as any reference options are exercised.
  - Since FAS 123R precludes consideration of forfeitures when estimating grant date fair value of employee stock options, the ESOARS payments are adjusted to eliminate the effects of forfeitures of unvested employee stock options.
    - The total payments made to holders of ESOARS will be equal to the amount they would have received if all of the reference options had vested, assuming similar exercise patterns for the options forfeited prior to vesting as the options that did actually vest.
    - If all of the reference options are forfeited prior to vesting, the ESOARS holders receive the full value of their investment back plus interest.
- There are no special restrictions on the transferability or sale of ESOARS, although there is not expected to be a robust secondary market for the securities.
- ESOARS differ from previous attempts at creating a market-based stock option valuation security because the ESOARS track the future flows of net obligations facing the

company or net receipts by its employees from the option grant. Previous proposals, such as Cisco Systems 2005 approach, instead attempted to create a security that replicated the terms and conditions of an employee stock option.

— In an August 31, 2005 memorandum from the Office of Economic Analysis, the SEC concluded that of the two approaches ("terms and conditions" versus "tracking"), only the tracking approach appears likely to produce a reasonable estimate of the fair value of employee stock options.

How is the price of ESOARS determined?

- ESOARS are sold in a web-based, modified Dutch auction process. Zions Bancorporations' most recent auction on May 4-7, 2007 worked as follows:

  — First, Zions set the number of ESOARS to be sold at auction equal to 10% of the number of employee stock options granted (the "reference pool").

  — Over a period of several days, institutional and other sophisticated investors bid on the number of ESOARS they wished to purchase and the per-unit price they were willing to pay.

  — The price paid by all winning bidders was the "market clearing price," which is the highest bid price at which all of the ESOARS offered in the auction would be sold. The market clearing price becomes the per-option expense under FAS123R of the employee stock options in the reference pool.

  — The auction was considered an "open auction" in that the bidders knew whether their bids were above or below the current market clearing price, but the bidders did not have any specific information on the number or bid prices of competing bids.

Pros of the ESOARS approach

- Presumably, the main advantage to the ESOARS approach is lower employee stock option expense under FAS123R. The market clearing price for the May 4-7, 2007 auction was $12.06 per ESOAR unit, which the Company estimated to be 14% below its Black-Scholes model valuation.

- Under the FASB's fair value measurement principles, observable market prices are considered to be more accurate predictors of fair value than model-based valuation techniques (e.g., Black-Scholes and binomial models).

Cons of the ESOARS approach

- Because the ESOARS auction is a sale of company securities, the company must prepare the appropriate SEC filings (i.e., prospectus statements) at the time of each grant.

- A company must hold public auctions and analyze each one to ensure that the resulting valuation is suitable for use under FAS123R.

- The total payments made by the issuing company to ESOARS holders are uncapped. As a result, there is the risk that the total payments to ESOARS holders could far outweigh the proceeds received from the issuing company at sale of the ESOARS.

- Accounting uncertainty exists for the treatment of payments by the issuing company to ESOARS holders at exercise.

SEC Comments

In its October 17, 2007 letter, the SEC noted that Zions' approach only uses the bid side of the bid-ask spread to determine the market-clearing price. The SEC letter also stated that because ESOARS are a relatively illiquid security, the bid-ask spread could be large. By looking only at the bid price, Zions' auction process "could produce a downward-biased result," which would be unfairly advantageous to Zions (i.e., they would favor lower income on the value of 10% of all employee stock options granted in exchange for lower accounting cost on 100% of all the employee stock options granted).

The SEC letter also reminded Zions that a robust analysis must be performed following each auction of ESOARS to ensure that the resulting implied fair values are a reasonable estimate for the underlying stock options. In particular, the SEC suggested that Zions consider the following:

- Are there a sufficient number of bidders to constitute an active market?
- Do bidders have sufficient information to accurately value the investment?
- Does the pattern of bidding appear to reflect an active market?
- As long as a market-based valuation technique is in the development stage, how does the resulting valuation compare to a traditional Black-Scholes valuation?

Zion Bancorporation has a patent pending on the ESOARS design and market-pricing mechanism and hopes to offer their services to facilitate similar auctions to establish a market-based FAS123R compensation cost of stock options for other companies.

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This letter was prepared using SEC filings and information from Zions Bancorporation's website (www.esoars.com). This letter is intended to alert compensation professionals about developments that may affect their companies, and should not be considered or relied upon as legal or accounting advice. Specific questions should be referred to the company's legal counsel and professional accountants. General questions about this letter may be directed to Steven Knotz at 415-659-0201 or by e-mail at sknotz@fwcook.com or Cimi Silverberg at 312-332-0910 or by e-mail at cbsilverberg@fwcook.com. Copies of this letter and other published materials are available on our website, www.fwcook.com.