

## EMPLOYEE STOCK OPTIONS: STOCKBROKERS' GOLDMINE, EMPLOYEES' BUST

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Imagine you are a high-tech employee, familiar with bits and bytes not bids and asks. After years of hard work, you receive employee stock options worth hundreds of thousands of dollars. High-tech company employees during the 1990's struck gold with employee stock options. As high-tech companies' stock rose in the market, employees suddenly found themselves with options worth much more than their other assets combined.

To exercise an option, which would expire if left untouched, most employees called their stock option administrator and exercised via touch-tone telephone. After a deduction for the option cost and the applicable taxes, an "exercise-and-sell" resulted in cash. There was also an alternative to "exercise-and-hold" for stock rather than cash.

Left to their own devices, most employees exercised relatively few options for cash and paid down mortgages and education expenses, or funded retirement accounts. The remaining options accrued over time and became very valuable. Many high-tech employees were not market savvy. After all, they did not purchase their stock options in the market, they received them as compensation regardless of their investment acumen. They knew they needed professional investment advice to preserve this once-in-a-lifetime motherlode.

In the late nineties, certain securities brokers realized that employee stock option business was a goldmine. Brokers could rake in huge management fees and margin interest if they could convince employees to invest with them rather than cashing in options for mortgages, retirement funds, and the like.

By 1998, many brokers solicited employees at work, and put on "financial planning" seminars touting purportedly safe strategies for investing stock options. Especially plugged was the low maintenance, yet for brokers, highly compensating, exercise-and-hold strategy. As a hook, brokers hyped supposed long-term tax savings from holding stock for a year. They recommended that the employee exercise all of their options, hold the stock for a year, watch the stock go up in value as the broker and broker's analysts were virtually guaranteeing, and sell thereafter to realize profit at a lower tax rate.

To hold the most stock, and supposedly save the most taxes, brokers touted a "creditline." The creditline was used to cover option exercise costs and taxes (which brokers withheld at the lowest rate to maximize the amount of stock held - yet the customer bore the risk of not being able to pay the remaining tax later). Brokers also represented that the creditline could be used to purchase other stocks to supposedly provide portfolio diversification.

While glossing over their customers' questions, brokers sold themselves as full service financial advisers who put their clients first. They promised that in the unlikely event that the stock price went down, they would act to preserve an account's value. Brokers presented the exercise-and-hold strategy as tax-wise and conservative. Supposedly, systems were in place to make this a no-lose recommendation.

Not mentioned was the high risk of a super-leveraged, over-concentrated account, sensitive to the slightest market downturn, and -- unbeknownst to the customers -- devoid of the promised techniques to protect account value. The benign sounding creditline, which many employees believed was an unsecured line of credit, was really a margin loan subjecting the investor to risk of total loss. The brokers' "diversification" was a mirage. Instead, brokers margined stock purchases in the same sector as the company stock in which the customer was already concentrated. And, the addition of further margin added to the extreme account leverage. These customers had no idea how precariously their brokers had positioned their nest-egg.

As the stock market fell, the margin house of cards crumbled. Employees were shocked to see their account values evaporate as quickly as their brokers' empty promises at the hands of the previously unexplained margin call. The brokers' firms issued flurries of margin calls demanding cash or stock liquidations.

Brokers who had touted themselves as financial advisors, not just salespeople, had no meaningful financial advice to hedge, sell, or otherwise stop the accounts from sliding. Instead, brokers extolled their analysts' proclamations that stock was strong and price dips were temporary. Even in the face of margin calls, investors were told not to sell and "lock in losses" but to hold the stock. Trusting their advisors, many investors lost everything.

Because the exercise-and-hold strategy is risky, one wonders why brokers recommend it to anyone but speculative and already wealthy investors. The answer lies in brokers' compensation schemes. The exercise-and-hold strategy involved few transactions. Brokers could work less and profit more by charging asset-based management fees on accounts over-concentrated in fast-growing company stock than they could building a diversified, stable portfolio on a commission basis. And brokers charged management fees based not only on the stock in the account, but also on the margin balance upon which they already charged interest. In a bull market, a fee-based broker is incentivized to gamble customers' assets in riskier, leveraged, and fast growing stocks that swell the account and fee.

Perhaps what is most egregious about the exercise-and-hold strategy, so highly touted as a tax-wise scheme by brokers, is that it delivered no special tax-savings. The long-term capital gain rate would have applied whether or not the options were exercised-and-held, or sold and reinvested into a safe, diversified portfolio which was held for over a year. The employee stock option customer, placed by their broker into the exercise-and-hold strategy on the basis of tax savings, or any other false premise, was defrauded.