The Time Has Come for ESPP!

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Webcast Materials

www.sos-team.com/PDFS/espp.pdf

The Walrus and The Carpenter

"The time has come," the Walrus said,
"To talk of many things:
Of shoes--and ships--and sealing-wax--
Of cabbages--and kings--
And why the sea is boiling hot--
And whether pigs have wings."

– Lewis Carroll
The ESPP and The Stock Plan Manager

"The time has come," the CC said,
"To talk of many things:
Of stock -and match –and shareholders--
Of good discounts -- and offering--
And why dispositions must be tracked--
And the joys of expensing."

– SOS

Agenda

• The Case for ESPP
  – Statistics
  – Benefits for employees & company
• Plan Design, Administrative & Accounting Issues
• Steps to Implement
  – Research / Design
  – Board Approval
  – Vendor Selection
• Case Study – EMCOR Group
Survey Details

- [www.naspp.com](http://www.naspp.com) | Member Area | Surveys | Stock Plan Design Surveys
  - NASPP/KPMG: 2004 Stock Plan Design and Administration Survey

Survey Details

- NCEO / CEPI 2009 Employee Stock Purchase Plan Survey
  - 412 companies responded
  - National Center for Employee Ownership
    - [www.nceo.org](http://www.nceo.org)
  - Certified Equity Professional Institute; at Santa Clara University
    - [www.scu.edu/business/cepi/](http://www.scu.edu/business/cepi/)
  - Comprehensive survey results available by contacting the NCEO or CEPI
THE CASE FOR ESPP

ESPP Facts...

• Studies show ...
  – Companies with broad-based equity plans show better results than those with narrowly focused plans \(^1\)

• Satisfaction
  – Majority of respondents believe that the ESPP is positive: 30% describe it as “net beneficial” and 35% call it “an excellent use of corporate resources.” \(^2\)

\(^1\) Public Companies with Broad-Based Stock Options: Corporate Performance from 1992-1997, Blasi, Kroumova
\(^2\) NCEO./ CEPI.2009 ESPP Survey
ESPP Facts...

- Employee ownership tends to...
  - Improve company performance by aligning interests of workers and managers
  - Serving as collective incentive to improve teamwork and information sharing
  - 66% feel more invested in their jobs*
  - 50% say ESPP made them less likely to change jobs*
  - 65% say shows employer truly values employees*

*Data from “Bridging the Gap”, July 2008, Fidelity Stock Plan Services

ESPP Facts...

- Projected that 17% of US employers offer a stock purchase plan
  - As opposed to
    - 16% stock option plans
    - 9% restricted stock

- Are employees satisfied?
  - “very satisfied” or “somewhat satisfied”
  - 76% with plan performance
  - 79% with plan design

*Data from “Bridging the Gap”, July 2008, Fidelity Stock Plan Services
“How much do you agree or disagree that you are more loyal to your current employer as a result of the...plan your company has awarded you?”

ESPP Facts...

- ESPPs produce cash flow to the company
  - Employees contribute post-tax via payroll contributions to purchase stock
- ESPPs are never underwater
  - With discount / match / look-back, they are always a bargain - sometimes an incredible bargain!
- Company Tax Deductions
  - For qualified plans from disqualifying dispositions
  - Or for company match on non-qualified plans
- Encourages employees to save
  - Without “locking them in”
ESPP Overview

• What is an employee stock purchase plan (ESPP)?

• An ESPP is a type of broad-based stock plan that allows employees to acquire shares of their company’s stock by electively contributing after-tax payroll deductions.

• Often include:
  – Benefit of a discount on the purchase price or a matching contribution made by the employer

Concerns: Expensing ESPP

• ESPP Expense is a non-cash expense
• Pre FAS 123(R) studies indicate expensing has little effect on stock price*
  – Study 1: companies voluntarily adopting: Stock price increased average 3.65% over six-day window around announcement
  – Study 2: companies voluntarily expensing, conclusion – does not impact stock price
  – Study 3: 140 companies, results not statistically significant...
• Post FAS 123(R) studies*:
  – 53% of sell-side analysts don’t consider FAS 123(R) expense
  – Share prices for companies with significant expense underperformed the S&P 500 by about 2%
• Many feel plan’s return outweighs effects of expensing

Concerns: Shareholders

- 2003 Hager Study;
  - 91 companies in Canada and 54 in the US were surveyed:
  - Institutional and individual shareholders: more likely to look favorably upon broad-based stock plans than plans that just reward a few employees.
  - Returns found to be higher by about 1.78% in the US & 2.13% in Canada when broad-based plans announced

\[^{1}\text{NCEO : Stock Option Grant Announcements and Shareholder Value}\]

Why Now?

- In difficult economic times,
  - ESPPs can be a great motivational tool
  - Build
    - Company morale
    - Employee loyalty
    - ‘we’re all in this together attitude’
- Right now, ESPP gives employees benefit of purchasing potentially undervalued company stock at a discount
Why Now?

• No bonuses this year?
  – ESPPs provide companies a way to compensate their employees
  – Without having to raise salaries
• Is business slow?
  – ESPP raise capital / cash inflow
• Recent large sweeping changes?
  – Timely introduction of ESPP may help energize employees to contribute to new projects, initiatives, etc.
Plan Design: Qualified? Or Non?

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
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</table>
| Qualified | Higher participation levels by approx. 10%¹  
| | Opportunity for favorable tax treatment at purchase  
| | Tracking dispositions (for all time)  
| | Regulatory requirements (6039, W-2 reporting, etc.)  
| | Must be non-discriminatory  
| Non-Qualified | More flexibility in design/participation  
| | Fewer regulatory requirements  
| | Simplified accounting treatment  
| | Easier to explain to employees  
| | No opportunity for favorable tax treatment at purchase  
| | Some may expect qualified, depending on industry/prior experience  
| | Shareholder perception may be an issue? |

¹2007 NASPP / Deloitte Survey.
Plan Design: Discount?

*Data from 2008 NASPP./ Deloitte Tax International Stock Plan Survey.*

Plan Design: To Lookback or Not?

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Look-back</td>
<td></td>
</tr>
<tr>
<td>• Better benefit to employees</td>
<td>• Requires expensing</td>
</tr>
<tr>
<td>• Better participation?</td>
<td>• Increases expense</td>
</tr>
<tr>
<td></td>
<td>• Fewer employees understand/value</td>
</tr>
<tr>
<td></td>
<td>• Reduces cash inflow</td>
</tr>
<tr>
<td>No Look-back</td>
<td></td>
</tr>
<tr>
<td>• Reduces expense</td>
<td>• Lower participation?</td>
</tr>
<tr>
<td>• Can be considered non-compensatory (no</td>
<td>• Opportunity for employee gain less</td>
</tr>
<tr>
<td>expensing) if discount &lt; 5%</td>
<td></td>
</tr>
</tbody>
</table>

*2007 NASPP./ Deloitte Survey.*
Plan Design: Length of Offering

- Three months to... 27 months...
- No reason for longer offering if no lookback offered
- Shorter offerings: Employees become shareholders faster and see benefit faster
- Employees less worried about share plans because more variance in purchase price with more frequent purchases
Length of Offering Period: Trends

*Data from 2004 & 2007 NASPP./ Deloitte Surveys.

Frequency of Purchase

*Data from 2008 NASPP./ Deloitte Tax International Stock Plan Survey.
Accounting for 423-ESPP: Overview

- **FAS 123(R)**
  - If “option-like” features OR > 5% discount = compensatory
  - Grant-date Fair Value – basically Black-Scholes but...
  - Three components:
    - Discount,
    - Call,
    - Put
  - Created using Enrollment Date market value
  - No “expected” term – term is known
  - Non-compensatory – no fair value, no expense

### ESPP Fair Value Components

<table>
<thead>
<tr>
<th>Plan Feature</th>
<th>Description</th>
<th>Fair Value Component</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount</td>
<td>% of discount</td>
<td>Discount</td>
</tr>
<tr>
<td>Lookback</td>
<td>Ability to purchase at LOWER market value between beginning of offering period market value &amp; purchase date market value. Ability to benefit from increase in stock price.</td>
<td>Call Black-Scholes Option</td>
</tr>
<tr>
<td>No beginning price limit</td>
<td>Ability to purchase MORE shares if price declines (number of shares to be purchased not limited by Ability to benefit from decrease in stock price.</td>
<td>Put Black-Scholes Option</td>
</tr>
</tbody>
</table>
Plan Design: Participation

- **Qualified Plans:**
  - To ensure plan is non-compensatory,
    - Exclude 5% owners, but include virtually all of your remaining employees with the exception of:
      - Part time employees (less than 20 hours per week)
      - Employees who have been employed less than 2 years
      - Employees who work less than 5 months each year
      - Highly-compensated employees
      - Employees of foreign subsidiaries
  - Groups can be excluded, however many companies try to include all full-time employees even if they have been employed less than 2 years
- **Non-qualified** – Can include/exclude as design decision

Plan Design: Shareholder Approval

- **423-Qualified Plans**
  - Required for 423-qualified plans
  - Required within 12 months, before or after the plan approved by the Board
  - Approval is only required once except for an increase in the number of shares
- **Non-qualified Plans**
  - Required by NYSE / NASDAQ – Changed in 2003
  - Even if “arguably” de minimis potential for insider compensation OR material dilution for shareholders
Plan Design: Enrollment Period

- **Choices**
  - **Window**
    - Open window during which employees may enroll in new offering period and make changes to elections.
    - Enrollment choices made for one period roll into next period unless employee elects to make a change
    - Outside of window, employees only allowed to withdraw
  - **Providing employees with the most flexibility will result in higher overall participation**
    - No one wants to be locked in for long periods of time
    - But more administrative burden
    - Depending on changes allowed – may increase expense

Contribution Limit

- **Qualified plans**
  - $25K contribution limit
  - Based on the value of shares purchased in the calendar year based on the FMV at the beginning of the offering period

- **Companies also limit**
  - Number of shares to manage dilution share reserve
  - Share limits not required
  - Add complexity to plan administration and employee communication process
  - May be best practice – can control burn rate
  - May be required for qualified plans under proposed 423 regulations
**Types of Limits**

*Data from NASPP / Deloitte 2007 Survey.

**Plan Design: Contribution Type**

- Percent or $ Amount?
  - Dollar amount easier to understand?
  - Employees know exactly how much will be deducted from their pay each period.
  - Percentages or a combination of both require the employee to calculate the amount of the deduction and can be cumbersome.
Impact of Changing Discount / Look-back

- ESPPs administered by Fidelity that reduced their discount rate from 15% to 5%
  - Average participation rates dropped 50%\(^1\)
- Other Changes:
  - Lowering discount to 10%
  - Removing lookback, or
  - shortening the offering period
  - had "no substantial impact" on plan participation\(^2\)

\(^1\)Fidelity StockSense Spring 2007 Newsletter
\(^2\)NASPP Stock Plan Advisor, September-October 2007

Automatic Resets

- If price drops during offering period, after next purchase
  - Price is reset or
  - Participant is automatically re-enrolled at new, lower price
- Excellent benefit to participants, but...
  - Triggers modification accounting
  - Few systems can support
  - Manual workarounds/spreadsheets often required
Plan Design: Share Funding

- Treasury/Reserve (authorized/unissued) is most common
- Open market purchase
  - May have an impact on your stock price based on the number of shares required for purchase / trading volume

Plan Design: Restrictions

- Often done to ease tracking dispositions for 423-plans
  - Any restriction on transfer/sale
  - Direct impact on the level of participation
  - Vendors can assist with disposition tracking to avoid any restrictions on sales or transfers
- Also used to encourage ownership
  - Instead of flipping shares immediately after purchase for quick gain
International Plans

Do you extend your ESPP to non-US countries?

- 16.50% Do not extend to Non-US countries
- 26% Extend to some countries
- 32% Extend to most countries
- 25% Extend to all countries

*Data from NCEO/CEPI 2009 ESPP Survey.

Ways to Reduce Expense

- Fair Value
  - Shorten offering period
  - Eliminate lookback
  - Reduce discount
  - Eliminate automatic reset
  - Limit employee ability to change contributions

- Administrative
  - Leverage your provider – disposition tracking, communication, etc.
<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Tax Benefit</th>
<th>Provides Discount</th>
<th>Used in Performance Incentive Program</th>
<th>No Shareholder Approval Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualified</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Section 423-Qualified Plans</td>
<td>Stock offered to all employees, often at discount, using treasury or authorized / unissued shares.</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>Non-qualified</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributory Plans</td>
<td>Company contributes specified $ amount and/or non-qualified $ toward employee stock purchased on open market.</td>
<td>☐</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>Discount / Match Plans</td>
<td>Stock offered to employees at a discounted price or can contribute % or all in a match.</td>
<td>☐</td>
<td>☐</td>
<td>☒</td>
</tr>
<tr>
<td>Open Market Plans</td>
<td>Shares purchased on open market with payroll deductions. No discount or company contribution.</td>
<td>☒</td>
<td>☐</td>
<td>☒</td>
</tr>
</tbody>
</table>

1Required by NYSE / NASDAQ for many plans.
Grid adapted from Computershare ESPP materials.
Steps for Implementing

- Determine Plan Design
  - Type of plan (qualified/non-qualified)
  - Amount of discount or match
  - Offering and purchase frequency
  - Amount of shares required & type (treasury, open market, authorized/unissued)
- Present to Board of Directors
- Seek shareholder approval
- Select a provider for administration and communication

Presenting to Board and Shareholders

- Highlight benefits of offering an ESPP
  - For employee AND
  - Company
- Provide high-level estimate of cost of implementing an ESPP (can vary based on the amount of discount/match)
  - Number of expected participants
  - Amount of discount/match
  - Administrative costs
- Engage an expert to gauge likelihood of shareholder approval
Selecting a Provider

- Industry experience
- Partnership approach
- User-friendly systems and reports
- Communication expertise
- Fees

Implementation Overview

- Prepare implementation project plan with timeline and milestones
- Discovery process and procedural requirements
- Database and administrative platform setup
- Establish system interfaces with payroll and HRIS systems/employee and plan sponsor website/IVR
- Prepare communications strategy
CASE STUDY: ESPP AT EMCOR GROUP, INC.

EMCOR Group, Inc.

- Fortune 500 Company with over 25,000 employees
- A leading provider of critical infrastructure systems
- EMCOR builds, powers, services and protects for maximum performance
- Markets include energy, transportation, health care, water, government, education, technology, hospitality
EMCOR’s ESPP

- Background
  - EMCOR has annual management conference each fall
  - Employees submit questions for a company-wide webcast
  - In Fall of 2006, commitment was made to employees to explore offering an ESPP

Process -- 2007

- Explored alternatives, design issues, cost and administration methods
- First: Winter 2007
  - Established purpose of ESPP
  - Fleshed out design alternatives and associated requirements (i.e., qualified/non qualified, FAS 123R, tax considerations) for presentation to executive management committee (EMC)
Process -- 2007

- Next: Spring – Fall 2007
  - 3 discussions with EMC
    - First meeting to provide full scope of alternatives and sense general direction
    - Second discussion to narrow down alternatives and follow up on questions
    - Third discussion to solidify decisions
      - Numerous scenarios were presented to model various levels of company match/discount, participation and stock price assumptions
  - Initial proposal presented to BOD by CEO to gain approval to proceed

Process -- 2008

- Winter 2008
  - Vetted final design with stock plan consultant
  - Determined number of shares to reserve
  - General Counsel determined type of shares to reserve for Plan (authorized/unissued shares)
  - Final proposal approved by Board of Directors
EMCOR’s ESPP Design

- Nonqualified ESPP
  - Offer only to non-union employees (around 8,000)
  - Offer a flexible design
- Quarterly offering periods; monthly purchases
- Employees contribute 1 – 6% of pay
- 10% company match
- No holding periods required
- Purchase whole and fractional shares

Implementation Process -- 2008

- Searched for consultant to partner with on vendor search
- Selected consultant and commenced search in April
- Consultant had robust, diligent selection process
- Obtained shareholder approval in June
- Selected Vendor in June
Implementation Process -- 2008

- Held first kick-off meeting with Consultant and Vendor teams in July 2008
- Held weekly team meetings with EMCOR, Consultant and Vendor
  - Vendor prepared enrollment guide to supplement plan document & prospectus (from Legal)
- Successfully implemented ESPP on time for October 1, 2008 quarterly enrollment
- Held subsequent weekly meetings with Vendor and Consultant until November

Enrollment Statistics

- 4 quarterly enrollment periods
  - October 2008: 500 participants (6.2%)
  - January 2009: 600 participants (7.7%)
  - April 2009: 675 participants (8.1%)
  - July 2009: 700 participants (8.5%)
  - Average contribution 3.5%
- Introduced in tough economy
- Expect participation to grow over time
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APPENDIX
Length of Offering Period: 423 Plans

*Data from 2008 NASPP/ Deloitte Tax International Stock Plan Survey.

Ways to Reduce Expense

<table>
<thead>
<tr>
<th>Method</th>
<th>Impact</th>
<th>Why?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shorter Offering Period</td>
<td>Reduces Fair Value</td>
<td>Shorter &quot;expected term&quot; = lower valuation</td>
</tr>
</tbody>
</table>
| Reduce / Eliminate Lookback   | Eliminates / reduces “call” part of fair value | • No benefit from increase in stock price  
|                               |                                 | • Participants MAY not value lookback as much as discount.¹           |
| Eliminate auto-reset          | Eliminates modification accounting | No changes to “grant” after enrollment – no incremental expense or additional expense for additional shares |
| Limit Ability to Change Contributions | Eliminates modification accounting | No changes to “grant” after enrollment – no incremental expense or additional expense for additional shares  
|                               |                                 | No “wasted” expense                                                   |
| Limit Transfers               | More tax deductions             | Capture ALL the tax deduction to which company is entitled           
|                               |                                 | Reduce survey costs                                                  |

¹Fidelity StockSense Spring 2007 Newsletter
Which Exchange Rate?

Which Exchange Rate do you use? (n=60)

- Exchange Rate on/around purchase date: 54%
- Exchange Rate on each contribution date: 13%
- Average exchange rate over offering period: 7%
- Exchange rate determined monthly: 9%
- Exchange rate at start of purchase period: 17%
- Other: 0%

*Data from 2008 NASPP./ Deloitte Tax International Stock Plan Survey.

How withholding is done?

For countries that require tax withholding on purchases under ESPP, how do you collect the tax withholding? (n=60)

- Local payroll deducts from pay: 43%
- Local payroll collects: 19%
- Do not offer where w/h req: 3%
- Share withholding: 1%
- Apply portion of contributions: 4%
- Sell-to-cover: 34%

*Data from 2008 NASPP./ Deloitte Tax International Stock Plan Survey.