



Certified Equity Professional Institute

A Fresh Look: Employee Stock Purchase Plans

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Materials

<http://www.sos-team.com/pdfs/espp2012.pdf>

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Stock & Option Solutions (SOS) is a leading stock administration staffing, consulting and outsourcing firm within the equity compensation marketplace.

SOS People/Staffing

Tactical to senior experienced consultants

- Day-to-day assistance
- Coverage for vacancies
- Vacation, medical, maternity leaves
- Project assistance
- Backing during high-volume
- Throughout United States

Flexible lengths of assignments

- Full or part-time assistance
- On-site or remote
- Temp to perm Services

Dedicated call centers

- Tender offers
- New plan implementations
- High-activity periods

Fulfillment Center

- Printing & mailing of participant communications

SOS Projects/Consulting

- Best Practice Assessment / Implementation
- SOS 6039 Full Service Outsourcing
- Equity Accounting Assistance
- Custom Reporting
- Software Upgrades
- Stock Plan Training
- Vendor Analysis & RFP

Transactions

- Mergers & Acquisitions
- Option Exchanges / Repricings
- Vendor or System Conversions
- IPO (pre and post)

Applications

- SOS Email Xpress
- SOS Participant Portal
 - Online grant agreements, ESPP Enrollment, confirmation statements, tax information, 6039 consent
- SOS 6039 Xpress
- Tender Offer Website
- Consent Website (6039, Proxy)

SOS Outsourcing

- The first complete outsourcing solution
- Manage some or all aspects of your stock plan administration
- Financial, Accounting & Tax Reporting
- Special Projects and Onsite Needs

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GPS History

- CEPI history
 - Education and certification since 1989
 - Research initiative introduced in 2007
- Industry feedback reflects broad and basic need
 - Internal controls
 - Best practices
 - Focus on administrative needs
- Research
 - 2007: NQSOs
 - 2008: Restricted Stock and Restricted Stock Units
 - 2009: Global Stock Plans
 - 2010: Performance Awards
 - 2011: Employee Stock Purchase Plans

2011: GPS| Employee Stock Purchase Plans

www.scu.edu/business/cepi/gps_project.cfm

- Strategic Issues
- Plan Design
- General Administration
- Plan Enrollment
- Contributions to the Plan
- The Purchase
- Tax Issues
- Legal
- Employee Communication
- Financial Reporting



2011: GPS| Employee Stock Purchase Plans

Bank of America
Merrill Lynch



Computershare

Turn here™



EXTRADE
CORPORATE SERVICES



Morgan Stanley
Smith Barney

BAKER & MCKENZIE

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ERNST & YOUNG
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Back to Basics – ESPP Considerations

- Broad-based, optional plan
- Allows regular purchase of shares, usually funded through payroll deductions (after tax)
- Possible discounts; employer match
- Section 423
 - ↑ Potential favorable tax treatment
 - ↓ Administratively more challenging (Dispositions and 6039)
- Non-Section 423
 - ↑ More flexibility in design; easier accounting; simpler communication
 - ↓ No opportunity for favorable tax treatment

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Back to Basics – ESPP Considerations

- **Guaranteed appreciation**
 - Right combination of offering period, discount and lookback
 - Never underwater if you offer a discount
- **Cash inflow**
- **Engaged employees**
- **Non-excessive**
- **Low compensation costs**
- **Company tax deduction**
 - Section 423 – upon disqualifying disposition
 - Non Section 423 – upon purchase

Section 423 Requirements

- **Employees only**
- **Shareholder approval**
- **5% owners excluded**
- **Non-discriminatory**
- **Equal rights and privileges**
- **Option price limitations**
- **Option period limitations**
- **Annual limit**
- **Non transferrable**

Separate offerings can include variations in terms among corporate entities – particularly useful for non-US employees.

Sizing It Up NASPP 2011 Domestic Stock Plan Administration Survey

- 52% of companies offer ESPP
- Why ESPP?
 - Promote employee stock ownership
- Plan features:

	423 Plans	Non 423 Plans
Most Common Discount	15%	0% and 15 % tied
Most Common Offering	6 months	3 months
Lookback	62%	30%
Required Holding	20%	15%
Quick Sale	5%	4%
US participation 50% +	25%	13%

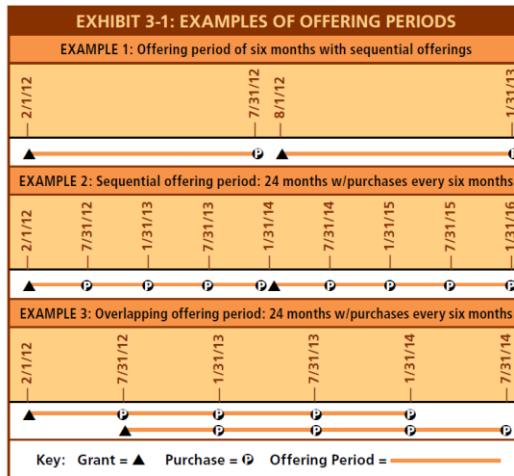
ESPPs – Expense Efficiency

EXHIBIT 2-1: FINANCIAL IMPACT OF PLAN DESIGN FEATURES

Assumptions: • \$10 stock price • 50% volatility • 0.25% risk-free interest rate • 0% dividend yield			
	6 Months	12 Months	24 Months
No look-back, 5% discount	\$0	\$0	\$0
Look-back, 5% discount	\$1.90	\$2.47	\$3.26
No look-back, 15% discount	\$1.49	\$1.49	\$1.48*
Look-back, 15% discount	\$2.90	\$3.47	\$4.25*

Compare to:
Option - \$4.88/share (no guarantees)
Restricted stock - \$10/share

ESPP Design Basics



- Longer offerings need to consider
 - Lookback
 - Reset
 - Changes to contributions
 - Financial reporting expense

ESPP – Expense Modifications

- Certain design features trigger modification accounting
 - Resets – resets lookback price
 - Rollovers – new offering with lower price
 - Increases in contributions within an offering period
- Design features that do not trigger modifications, but require special attention
 - Decreases in contributions – IGNORE!
 - Voluntary withdrawals without termination – IGNORE!
 - Salary changes – adjust expense
- Only true up to actual shares purchased for:
 - Terminations
 - Salary increases, bonuses, etc.

Plan Design

Understanding Lookback Value to Employees

EXHIBIT 3-2: QUALIFIED PLAN WITH NO LOOK-BACK

Plan Provisions:	6 months		
Offering period	85% of fair market value on purchase date		
Offering price	\$1,000 total (prorata amount deducted from each paycheck)		
Contribution	No		
Inclusion of look-back	No		
	Depreciating Stock Price	Flat Stock Price	Appreciating Stock Price
Assumptions:			
Stock price at beginning of offering period (A)	\$10.00	\$10.00	\$10.00
Stock price at end of offering period (B)	\$8.00	\$10.00	\$12.00
Purchase price (C=85% of B)	\$6.80	\$8.50	\$10.20
Shares purchased (D=1,000 divided by C)	147.0588	117.6471	98.0392
Shares purchased not limited by Plan			
Fractional shares issued			
Value from discounted offering price	\$176.47	\$176.47	\$176.47
Value from look-back	\$0.00	\$0.00	\$0.00
Total value delivered [(B - C) X D]	\$176.47	\$176.47	\$176.47

- Lookback adds value only with an appreciating price; no value in flat or depreciating price.

- Cost can be managed by offering lookback without reset or contribution changes

EXHIBIT 3-3: QUALIFIED PLAN WITH LOOK-BACK

Plan Provisions:	6 months		
Offering period	85% of fair market value on lower of FMV on grant date or purchase date		
Offering price	\$1,000 total (prorata amount deducted from each paycheck)		
Contribution	Yes		
Inclusion of look-back	Yes		
	Depreciating Stock Price	Flat Stock Price	Appreciating Stock Price
Assumptions:			
Stock price at beginning of offering period (A)	\$10.00	\$10.00	\$10.00
Stock price at end of offering period (B)	\$8.00	\$10.00	\$12.00
Purchase price (C=85% of lesser of A or B)	\$6.80	\$8.50	\$8.50
Shares purchased (D=1,000 divided by C)	147.0588	117.6471	117.6471
Shares purchased not limited by Plan			
Fractional shares issued			
Value from discounted offering price	\$176.47	\$176.47	\$176.47
Value from look-back	\$0.00	\$0.00	\$235.99
Total value delivered [(B - C) X D]	\$176.47	\$176.47	\$411.76

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Value of ESPP Components

Plan Feature	Description	Fair Value Component
Discount	% of discount	Discount
Lookback	Ability to purchase at LOWER market value between beginning of offering period market value & purchase date market value. Ability to benefit from <u>increase</u> in stock price.	Call Black-Scholes Option
No beginning price limit	Ability to purchase MORE shares if price declines (number of shares to be purchased not limited by price decline) Ability to benefit from <u>decrease</u> in stock price.	Put Black-Scholes Option

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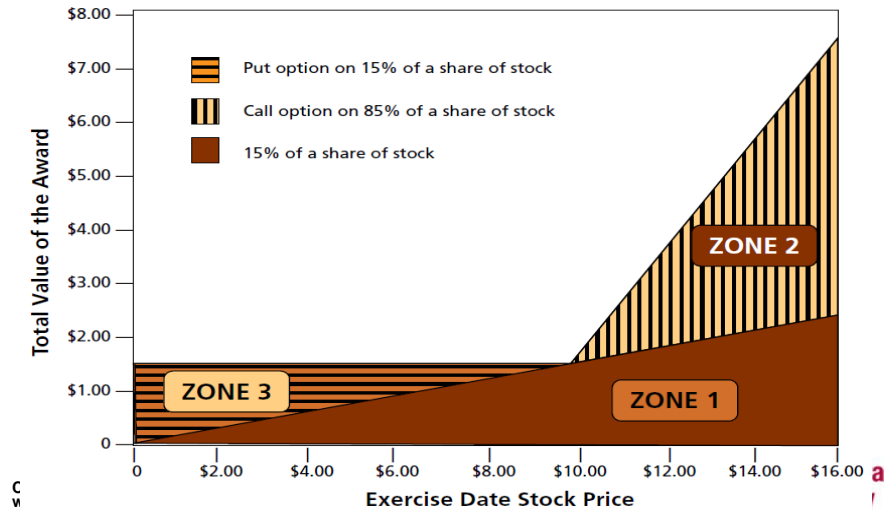
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Value of ESPP Components

EXHIBIT 11-1: VALUE OF ESPP COMPONENTS



ESPP Plan Types

EXHIBIT 11-2: SUMMARY OF ESPP PLAN TYPES

Type	Name	Distinction
Type A	Maximum Number of Shares	Maximum number of shares is determined on the date of grant using the FMV at the grant date
Type B	Variable Number of Shares	When the stock price declines, the employee is able to purchase more shares (i.e., there is no purchase price limit)
Type C	Multiple Purchase Periods	Longer look-back periods offer greater benefit to employees
Type D	Multiple Purchase Periods with a Reset	Reset protects against stock price declines since a look-back price is reset
Type E	Multiple Purchase Periods with a Rollover	If the stock price declines, the offering is restarted at lower price
Type F	Multiple Purchase Periods with Semifixed Withholdings	Allows increases or decreases to future contributions for future purchase periods within the offering period
Type G	Single Purchase Periods with Variable Withholdings	Allows increases or decreases to future contributions at any time
Type H	Multiple Purchase Periods with Variable Withholdings	Allows increases or decreases to future contributions at any time
Type I	Single Purchase Period with Variable Withholdings and Cash Infusions	Allows increases to past contributions and increases and decreases to future contributions at any time

Purchase Gotchas!

- **Plan parameters**
 - Read your Plan!
 - Confirm changes for system/providers
- **Eligibility**
 - Terminations/withdrawals
- **Reconciling contributions**
- **Purchase Price**
- **Residual Contribution Amounts**
- **Non-US**
 - Eligible compensation
 - Exchange rates
 - Documentation

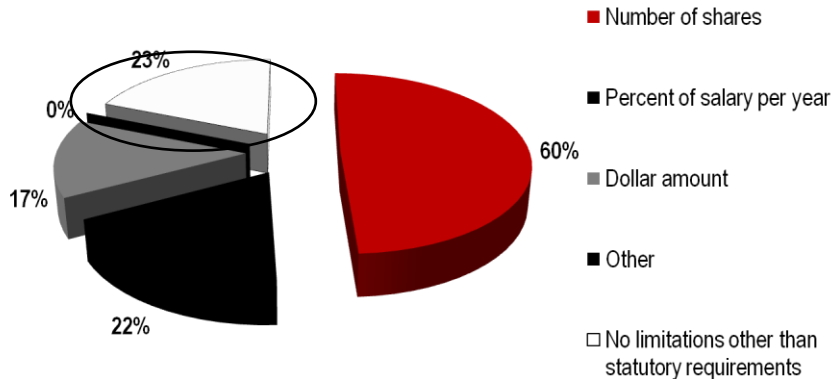
ESPP Limits

- **\$423 \$25,000 limit**
- **Individual share limits**
 - Must specify individual share limits (per person, per offering)
 - \$25K limit not acceptable
 - Doesn't have to be "realistic"
- **Beginning price limit**
 - Protects share reserves in declining market

EXHIBIT 3-5: USING A BEGINNING PRICE LIMIT	
Plan Provisions: Offering period Offering price Contribution	6 months Lower of FMV on grant date or purchase date \$10,000 total (prorata amount deducted from each paycheck)
Inclusion of look-back Beginning price limit	Yes Yes
Assumptions: FMV on grant date FMV on purchase date Maximum shares to be purchased	\$10.00 \$4.00 1,000 shares (\$10,000/\$10)
Price paid (\$6,000 of excess contributions refunded to the employee)	\$4,000 (1,000 x \$4)

Purchase Limits

How does the ESPP define the maximum amount of stock that can be purchased (excluding any statutory limits such as the \$25,000 limitation required under Section 423)? (Check all that apply.) (Section 423 Plan)



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Understanding the \$25,000 Limit

- **\$423 limits the purchase of stock to no more than \$25K each CY based on the FMV at the time of grant.**
- **\$25K limit increases by \$25K for each CY the option is outstanding**
- **If an employee has the right to purchase more than \$25K in a CY, the purchase is disqualified and the *entire* offering may be in jeopardy.**

EXHIBIT 3-9: \$25,000 LIMITATION FOR QUALIFIED PLANS

Assumptions:	
Offering period	January 1 – December 31, 2012
Offering price	85% of FMV on lower of FMV on grant date or purchase date
FMV on grant date	\$10.00
FMV on purchase date	\$12.00
Purchase price	\$ 8.50
An employee could purchase a maximum of 2,500 shares (\$25,000 / \$10 per share FMV on grant date) on December 31, 2012.	

EXHIBIT 3-10: CARRYOVER OF \$25,000 LIMIT

Assumptions:	
Offering period	September 1, 2012 – August 31, 2013
Offering price	85% of FMV on lower of FMV on grant date or purchase date
FMV on grant date	\$10.00
FMV on purchase date	\$12.00
Purchase price	\$ 8.50
An employee could purchase a maximum of 5,000 shares (\$50,000 / \$10 per share FMV on grant date) on August 31, 2013, representing \$25,000 relating to 2012 and \$25,000 relating to 2013.	

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Qualifying vs. Disqualifying What a Difference a Day Makes!

QUALIFYING VERSUS DISQUALIFYING DISPOSITIONS

Caution – To receive preferential tax treatment an employee must hold shares purchased under a qualified plan at least two years from the date of grant and one year from the date of purchase. A sale of the stock on the one-year anniversary date of the purchase is a disqualifying disposition. For example –

Beginning of the offering period	February 1, 2011
Purchase of the stock	February 1, 2012
Sale of the stock	February 1, 2013

The sale of stock on February 1, 2013, would be a *disqualifying* disposition. The sale of shares on February 2, 2013 would be a *qualifying* disposition.

- Understand and communicate qualifying vs. disqualifying
 - Address in employee communications.

Tackling Taxes Understanding US Employee Taxation

EXHIBIT 8-2: TAX CONSEQUENCES TO THE EMPLOYEE

	Nonqualified Plans	Qualified Plans
Grant	None.	None.
Contributions	Made with after-tax dollars.	Made with after-tax dollars.
Purchase	FMV on the purchase date minus the purchase price is taxable ordinary income at the time of purchase.	None.
Sale	Sale price minus the FMV on the purchase date is a capital gain or loss.	Qualifying Disposition - If the stock is held at least two years from the date of grant and one year from the date of purchase, ordinary income is recognized on the lesser of: <ul style="list-style-type: none"> • The difference between the FMV of the stock and the purchase price on the grant date, or • The actual gain (sale price minus the purchase price), if any If the sales price is less than the purchase price, the difference will be a long term capital loss. If the sales price is greater than the FMV of the shares on the grant date, the difference will be long term capital gain.
		Disqualifying Disposition - If the stock is not held at least two years from the date of grant and one year from the date of purchase, ordinary income is the FMV at the purchase date minus the purchase price. The sales price minus the FMV on the purchase date is a capital gain or loss.

Tackling Taxes Understanding Employer Taxation

EXHIBIT 8-7: EMPLOYER WITHHOLDING AND REPORTING RESPONSIBILITIES		
	Qualified Plans*	Nonqualified Plans
Grant	None.	None.
Contributions	None.	None.
Purchase	None.	Difference between the FMV at exercise and the purchase price paid is taxable as ordinary income. Income tax and social tax must be withheld. Ordinary income is reported on Form W-2, box 1.
First transfer of legal title of shares purchased**	Reported on Form 3922 to the IRS and the employee.	None.
Sale	<p>Qualifying Disposition: Ordinary income on the lesser of:</p> <ul style="list-style-type: none"> • The difference between the FMV of the stock and the purchase price on the grant date or • The actual gain. <p>This amount is reported on Form W-2, box 1. No income or social tax withholding is required. Disqualifying disposition: Ordinary income on the FMV at the purchase date minus the purchase price and is reported on Form W-2, box 1. No income or social tax withholding is required.</p>	None.

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3922 Requirements

- §6039 requires Form 3922 for the first transfer of legal title of shares of stock purchased under a 423 plan
 - nonqualified plans are exempt
- Depositing shares into individual brokerage accounts or an omnibus account is considered the "first transfer of legal title."
 - Post purchase restrictions do not impact
- Filed with IRS *and* sent to the employee or former employee
 - Substitute form (for employee only) can aggregate transactions
 - Nonresident aliens (no W-2) exempt
- **Caution – Acquiring companies *can* assume filing responsibility, but ultimate obligation belongs to acquired company.**

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3922 Requirements

- Filed with IRS *and* sent to the employee or former employee
 - Substitute form for participant form can aggregate transactions
 - Nonresident aliens (no W-2) exempt

EXHIBIT 8-8: FORM 3922 FILING REQUIREMENTS		
	Due Date	Other Comments
Paper filing	February 28 of the following year	Permissible only if the company has fewer than 250 reportable transactions
Electronic filing	March 31 of the following year	Required if the company has 250 or more reportable transactions in a year
Employee	January 31 of the following year	Substitute forms may be used to combine multiple transfers on a single form. Substitute forms must include "substantially the same" information noted above.

Sector Differences*

- Technology companies
 - More likely to offer large discount than manufacturing or financial
 - Heavily weighted towards longer offering periods
 - 15% of them have periods of three months or less.
 - More than half of financial companies have short offering
 - More satisfied with their plans
 - None reported plans were "not worth it"
 - Nearly half call their ESPP "an excellent investment."
- Manufacturing least satisfied with their plans

*NCEO/CEPI 2009 ESPP survey
www.nceo.org/main/misc.php?id/152/

Plan Design and Satisfaction*

- **Discounts**

- Higher discount rates = twice as likely to be highly satisfied

- **Lookbacks**

- 46% of companies with lookbacks call their plan an “excellent use of corporate resources”
- 17% of companies without lookback call their plan an “excellent use of corporate resources”

- **Offering Length**

- Longer offering periods = greater satisfaction
- No companies with offering periods of 12 months or longer were dissatisfied

*NCEO/CEPI 2009 ESPP survey
www.nceo.org/main/misc.php?id/152/

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Parting Thoughts and Questions

- **ESPPs are a cost effective way to share equity on a broad basis**

- **ESPPs deliver many of the “positive” attributes of other forms of equity*:**

- Employee satisfaction with stock plans same for ESPP-only participants as for participants with RS/options - ~55% with high satisfaction
- Engagement - ESPP-only participants are only slightly less aware of current stock price than RS/options participants
 - 86% vs. 92%
 - ESPP-only participants are more likely to check after each purchase period - 74% vs. 66%
- Just as likely to want future employers to offer a stock plan (~85%)
- Motivation - 50% of ESPP-only "work harder" vs. 61% of RS/options.

* Fidelity Stock Plan Services Participant Research, 2011

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