Design Considerations for Employee Stock Purchase Plans (ESPP)

Designing a Plan that Minimizes Risk and Cost and Maximizes Employee Benefits

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Major Features of an ESPP

- Offering Period
- Purchase Period
- Discount Percentage
- Look-back Provisions
- Fair Market Value
- Eligibility
- Limits
- Share Allocation / Authorization
- Qualified / Non-qualified Status

Key Decisions for an ESPP

- Eligibility Requirements (US and International) – legal issues, communication issues, participation issues
- How to enroll and important deadlines (do they have to re-enroll every offering period?)
- Definition of the Offer date (grant date) and Purchase date (exercise date) and the rules for both
- How Fair Market Value is defined, and what to use for non-market, no trading, IPO date etc.
- Discount Percentage (impact on limits, impact on accounting, impact on participation)
- Minimum and maximum contribution percentage allowed
- When and how an employee can increase, decrease and withdraw
- Who formally administers the plan and who can change/amend it?
- Limits and what to do when they are met:
    - Plan Limits (total plan, offering period, purchase period)
    - Individual "hard" Share limits
    - Individual "calculated" share limits
    - $25K limit (or lesser replacement)

Key Decisions for an ESPP (cont.)

- What happens to the contributions with a LOA or upon Termination
- Carry-Forward and Refund rules. When, How
- Whole or Fractional Shares?
- Contribution Currency conversions, when and what source
- Quick-sale provisions
- Communication, Education and Training (staff and management)
- Coordinating Payroll, HR, Broker, Transfer Agent and Stock Admin
- Who clerically administers the plan?
- Insource or outsource?
- Reviewing the calendar – what else is happening at the time of enrollment
- Consider behavioral economics principles when creating the plan

Phases of FutureSense ESPP Plan Design

- Phase 1.
- FutureSense reviews corporate structure, current ownership positions and the corporate culture. The company is guided through a questionnaire that will help provide direction for specific design elements type of equity instrument(s) and plan goals. This phase includes stakeholder interviews to ensure that your company culture and goals are fully represented in the final plan design.

Phases of FutureSense ESPP Plan Design

- Phase 2.
- FutureSense determines the best plan type and features to support the goals of the plan. We review potential accounting and tax issues for each design element with identified stakeholders and external advisors. We then outline a plan structure that meets the goals of the company. We also provide explanations of key design elements and plan documents that will be ready for review by your legal counsel and accountants. Any design is structured to best allow for future evolution of the program to meet your needs. We also provide the details for provisions covering the determination of eligibility, grant prices, purchase schedules, leaver provisions, change in control and other required details. FutureSense participates in the review performed by the company's legal counsel and provides a final reading of the documents to ensure they still meet the intent of the company.

Phases of FutureSense ESPP Plan Design

- Phase 3.
- FutureSense works with the company to create an initial communication program to ensure that stakeholders, key investors and participants understand the program and its potential value to each of them. This includes common documents and presentations.
- Phase 4.
- FutureSense provides a detailed implementation project plan and recommendations for ongoing administrative solutions and support.

Minimizing Risks

Design Element	Risk	Mitigation
Share Usage	Running out of shares during a purchase	A) Plan Limits B) Individual Share Limits C) Frequent Modeling D) Asking for enough shares up front
Purchase Price / Discount	Purchase of shares at a price higher than employees could have on open market	A) Look-back discount B) More frequent purchases C) Larger discount
Purchase Price / Discount	Employees "lose" discount just after purchase	A) Quick-Sale provision B) Efficient Administration C) Earlier Payroll Cutoff

Minimizing Risks

Design Element	Risk	Mitigation
Eligibility at Purchase	Purchases by terminated employees	A) Earlier Payroll cutoff B) Tight link between HRIS and Stock Admin (especially for international)
Eligibility at Purchase	Purchase by International Employees	A) Have expert review potential "entitlement" issues B) Create non-qualified plan for international C) Require monthly audit
Fair Market Value (FMV)	Lack of clear definition, especially for non-market days	A) Clearly understand definition of FMV B) Use prior day prices when possible

Minimizing Costs

Design Element	Risk	Mitigation
Look-back Discount	"Option-like" condition results in compensation expense	A) Reduce Offering Periods
Discount Percentage	Discount of greater than 5% results in compensation expense	A) Measure compensation expense vs. lost participation B) Create purchase limits to "cap" potential expense
Purchase Frequency	Each purchase requires administrative time and effort	A) Monthly purchase periods lessen compensation expense and potential loss due to volatility B) Quarterly audits during any purchase period longer than 3 months

Minimizing Costs

Design Element	Risk	Mitigation
Plan Complexity	Unique plan provisions that are outside of administrative capabilities	A) Stay "vanilla" unless the feature is measurably valuable B) Have plan reviewed by admin experts BEFORE you get it approved
Timing	Are there other corporate activities scheduled during enrollment or purchases?	A) Consider off-calendar enrollment and purchase schedule

Maximizing Employee Benefit

Design Element	Risk	Mitigation
Contribution Methodology	Too many methods can cause confusion	A) Stick to a single method (preferably via payroll deduction) unless restricted by law
Discount Percentage	Discount not large enough to cover volatility and risk of time value of contributions	A) Consider a "look-back" and control corporate expense through design elements B) Focus plan on broad-based staff, not executives
Enrollment ease	Complexity during enrollment will reduce participation	A) Consider a default enrollment process B) Review number of steps

Maximizing Employee Benefit

Design Element	Risk	Mitigation
Withdrawal Rules	Employees withdraw during period due to hardship	A) Allow for suspension (reduce contribution to 0%) B) Allow LOA to retain grant date if it crosses multiple purchase periods
Proration when out of shares	Stock price drop results in potential purchase of more shares than are available.	A) Plan level share limits for every purchase period B) Individual limits C) Frequent modeling

Brief Overview of IRC 423 ESPP Rules

- Employees only: the company can choose to exclude ONLY the following:
  - Employed < 2 years
  - < 20 hours per Week
  - < 5 months per Year
  - "Highly Compensated" Employees (see IRC 414q)
  - Employees of certain subsidiaries
- Limit on Length of Offering (27 month if Look-back)
- Limit on Amount of Discount (15%)
- Dollar Limit on Number of Shares to be Purchased – Participant
  - Limit Based on Grant Price + Contributions
  - Limit Based on Ownership > 5%
- Share Limit Set at Grant – Participant
- Plan / Share Approval Issues
- Shareholders must approve prior to grant or company will suffer negative accounting impact

Eligibility Requirements

- Must include all full-time employees.
- Can exclude part-time employees who works less than 20 hours per week
- Can exclude part-time employees who work less than 5 months a year
- Can exclude employees who have worked for the company less than 2 years
- Must exclude anyone who owns more than 5% of the company's common stock
- International concerns with Works Councils, Securities rules, Monetary regulations, Income and tax issues etc.
  - Can exclude employees in specific subsidiaries
  - Certain countries make it almost impossible (Ex. China, Vietnam)

Enrollment and Deadlines

- Initial enrollment is most often performed online
- Ongoing participation is best if automated
    - Always carry into the next offering unless participant actively requests a withdrawal
- Auto-Withdraw/Re-enroll function
    - Specific to Offering Periods with multiple purchase periods and with a Look-back discount
    - Remove participant from higher priced offering and start them in a new offering with a lower grant date FMV
    - Provides lowest possible purchase, but can extend Disqualifying Disposition period

Offering Period and Purchase Period

- Offering Period: The period you get to keep your grant date and price and, if you plan has a Look-back, your Look-back price and associated discount
- Purchase Period: The period during which contributions are collected, ending on the Purchase Date
- Purchase Date: Date shares are purchased
- One Offering Period can contain one or many Purchase Periods
- One Plan can have many overlapping Offering Periods
- Offering periods with a Look-back can be as long as 27 months (but more than half are 6 months long)
- Purchase periods can occur as often or as infrequently as will fit into an offering period (but most match the 6-month Offering Period)
- A good practice is have a purchase in the middle of the month so it does not conflict with period closings and black-outs
- These are the major pieces of the foundation of your plan and are among the most important aspects in the consideration of risks, costs and benefits

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Offering Period and Purchase Period

Look-back or no Look-back, Pros and Cons

	Pros	Cons
Look-back	• Better Discount = Better Participation • Most common plan for Silicon Valley • Very low participant risk	• Compensation expense can be high for large plans, or poorly designed plans • Some shareholders do not like these plans
No Look-back	• Reduces or eliminates compensation expense • Simplifies administration • More in line with Euro-style plans	• Participation is generally very low (single digit %) • Poor participation can translate into cancellation • Uncompetitive with most start-ups and high growth tech firms

Fair Market Value (FMV)

- FMV is the the definition of the value of a share of stock on a given date
- You need to define the date or dates to be used
  - Often defined as current date, but may be fairer to use the average of multiple dates
  - Using the prior day's price allows for more efficient plan processing and quicker delivery of shares
  - Plan must be clear about how to handle non-market dates, even unplanned non-market dates
    - BTW: "Next Preceding Day", means "The Day Before"
- You need to define the price to be used
  - Average Price, Closing Price, Opening Price, High, Low
  - If using "closing price" you should define whether that is closing bid or ask price, or either
  - Using closing price on the current date means you must wait until at least 20 minutes after the market closes to get started on processing the purchase
- You may need to define a qualified source or source(s)
  - "Wall Street Journal" is the source definition in some plans – this isn't optimal as you have to wait until at least the next day, and it often does not match online numbers
  - Online resources should be carefully vetted to ensure consistency with other sources and the ability to not change historical prices without an audit trail function

Discount or Match

- Qualified Plans allow up to a 15% discount
- Discounts at or below 5% are considered “safe harbor” plans and do not result in any compensation expense
- Discounts make calculating and communicating the $25,000 limit more complex, but stock admin systems handle this very well
- Discount must be high enough to be an attractive alternative to simply dollar cost averaging of open market purchases over the same period as the plan purchase period
- Discounts and Look-backs are what make IRC 423 plans special in the world of compensation and benefits.
    - They combine the compensatory and benefit aspects into a program that requires a “skin in the game” investment from participants
    - They can provide an ongoing engagement component that links well with corporate messaging and shareholder concerns

Contribution Percentage and/or Dollars

- ESPP Contributions are calculated pre-tax, but withheld on post-tax dollars
  - Unlike 401(k) programs, ESPPs do not reduce your taxable income
- Best practice is to allow for whole percentage contributions
  - May not be allowed in some countries. Plan should include a provision that allows for lump-sum or other forms of contributions, upon approval
- Common structures are 1-10%, 1-15% and 1-25%
  - Some companies allow up to 100%
  - Limiting the percentage of contribution is generally done to help limit the shares purchased
  - Purchase limits can be usually be better constructed in other ways
- Allowing for contributions outside of payroll deductions can create large administrative burdens
- Allowing for payroll deductions without a tightly managed payroll functions (especially international) can result in long and expensive delays at time of purchase

Increasing, Decreasing, Withdrawing

- Increasing contributions is best restricted to only be allowed during open enrollment before the start of a new purchase period.
    - Easier on the Payroll department
    - Increase of contribution during the period may result in additional compensation expense
- Decreasing contributions to anything other than 0% is best restricted to only be allowed as of the start of a new purchase period
    - Easier on the payroll department
    - Less overall administrative burden
- Decreasing contributions to 0% during the middle of a purchase period can often work better than requiring a withdrawal
    - Allows for participants with hardships to remain in the plan
    - Allows for participants who are close to hitting limits to stop contributions early, rather than waiting for the purchase and getting a refund of unused funds
- Withdrawal from the plan means losing your grant date and associated price

The “Formal” Plan Administrator

- Nearly every plan uses the term “Plan Administrator”
    - This term refers to the Board of Directors, or subset of the Board that can define provisions of the plan, make amendments (that do not otherwise require shareholder approval), interpret provisions and give authorizations to use special features that were included for special issues
    - This is NOT the individual, outsourcing firms or other entity who manages the day to day clerical, processing, reporting and other duties associated with the plan
- The plan document should clearly document the authority of the Plan Administrator
    - Whoever is managing the day to day plan details should be acutely aware of what the Plan Administrator can and cannot do

Limits: Shares and Dollars, Hard and Soft

- Limits and what to do when they are met
  - Plan Limits (total plan, offering period, purchase period)
  - Individual “Hard” Share limits
  - Individual “Calculated” share limits
  - $25K limit (or lesser replacement)

Termination and LOA Rules

- Terminations can be broken into several subsets
  - Death
  - Disability
  - Voluntary
  - Involuntary (not for cause)
  - Retirement
  - For Cause
- Most companies do not allow terminated employees to participate in purchases
  - Some allow for purchases within two weeks or a month of termination. This allows for moving forward with purchases if if HRIS, Payroll and/or Stock Admin have issues verifying terminations on a timely basis
- Plan must define who can participate, and for how long after their termination date they can make purchases
  - This is especially important when a purchase occurs monthly, or when they occur at the end of a calendar year

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Termination and LOA Rules

- Leaves of Absence can be difficult to manage.
    - Plan must define if purchases can be made while on LOA
    - Must also define what happens for both short-term and Long-term LOA
- Plan should be clear on whether participation is continued or suspended during LOA.
    - Must be careful with Military LOA
    - If employment is guaranteed upon return
- Company must also make sure that these is no conflict between the ESPP definition of “employee” for purposes of the plan, and other company definitions of “employee” for purposes of other compensation and benefit plans.

Unused Contributions

- Contributions remain unused after a Purchase Date for two reasons
  - Too small an amount to purchase a whole share
  - Participant's purchase was limited and some funds could not be used to purchase shares
- Best practice is to carry forward the amounts too small to purchase a whole share
  - If at the expiration of a plan, refund these amounts
- Amounts remaining after hitting a limit should generally be refunded
  - Exception for refund may be made if company has very low limits. This allows for the next purchase period to be "pre-funded" and keeps the funds in the company's control. It also keeps the participant engaged in the plan
- Refund at the time of termination
  - Best practice is to deliver this as soon as practicable
  - Some plans delay this refund until the end of the purchase period

Whole or Fractional Shares

- Most plans restrict purchase to whole shares
  - This is easier for tracking and reporting
- Many brokerage and administrative systems support whole shares better than fractional shares
- Whole shares do create the need to calculate and maintain “carry-forward amounts OR
  - Your must transact many small refunds at the end every purchase period
- Reporting is also complicated when translating potential ordinary income amounts into fractional numbers of shares

FX – Currency Translation and Conversion

- Currency Conversion ONLY refers to the point in time when contributions in one currency are traded in for another currency
    - Currency Conversion requires a clear definition
    - Purchase pay includes more than one conversion
        - Conversion of contributions to make purchase in dollars
        - Conversion of proceeds from any sale of shares for delivery to participant in local currency
        - Conversion of unused contributions, due to refund (best practice is to only convert those funds actually being used to purchase shares)
- Currency Translation is the interim reporting of relative values
    - Currency Translation requires a consistent source, but that source may not be exactly the same as final conversion
- Most plans only convert currency just before the purchase is made, while translations are what is reported on participant websites
- Contribution conversions can also occur at interim intervals during a Purchase Period

FX – Currency Translation and Conversion

- The timing of contribution conversions can vary
  - Some companies convert all contributions on a monthly or quarterly basis, often using the rate they use for other treasury transactions
  - There is an FX risk, especially for larger plans, that must be managed
  - Risk to the participant is that FX rates will move in the opposite direction of the growing stock price effectively negating any growth in the price
  - Risk to the company is that potential currency conversion will be unplanned and unmanaged leaving the company open to potential exposure and missed opportunity to manage potential currency swings
- Some countries do not allow for funds to be easily moved and converted into dollars. Care should be taken to create proper processes for these countries

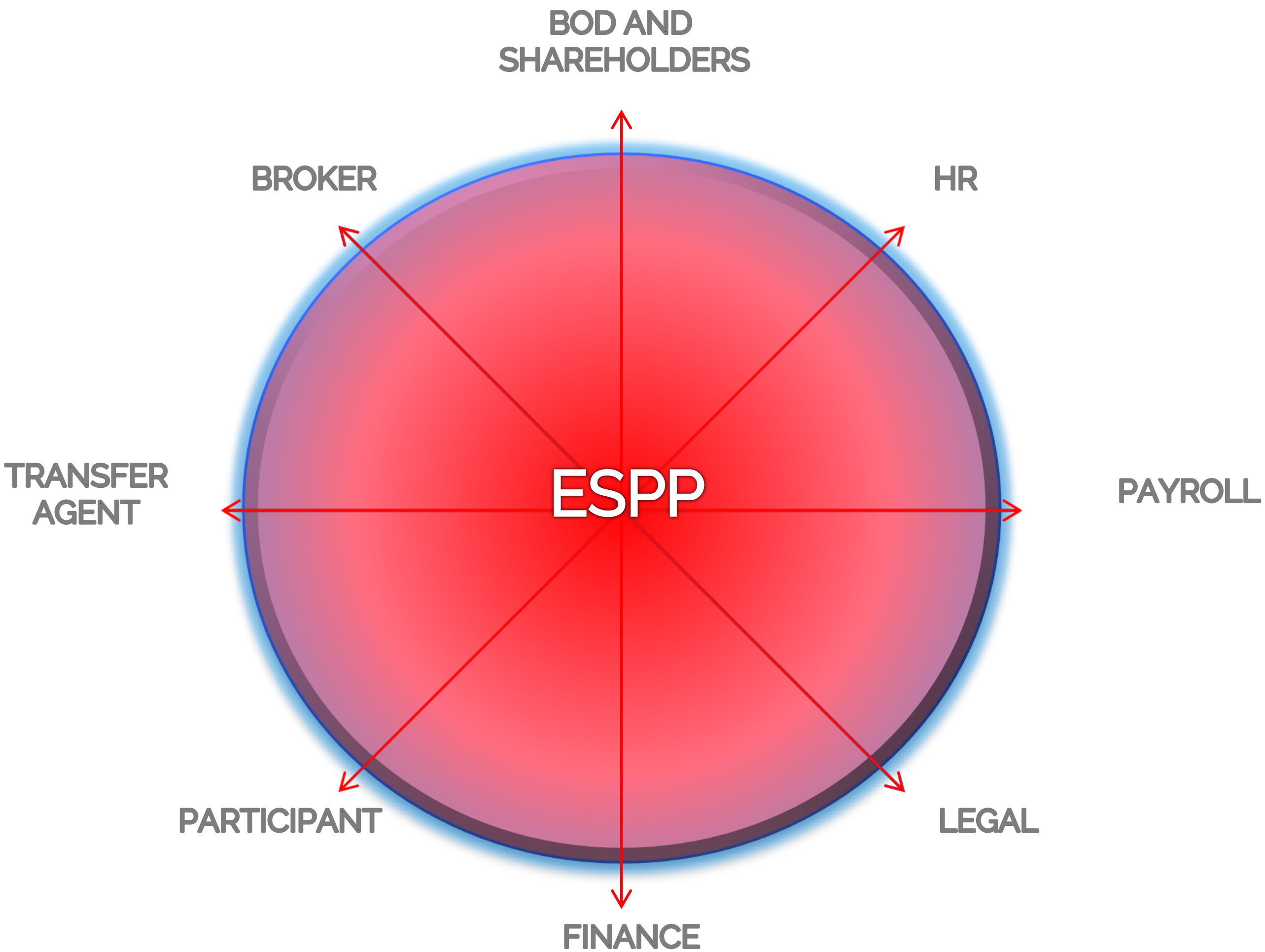
Quick-Sale, 10b5-1 and Other Sale Issues

- A “Quick-Sale” provision allows participants to make a pre-purchase election to sell shares as soon as they are available after the purchase date
  - Reduces risk of loss due to stock price drop after the purchase date
  - Especially effective with lower discounts
  - Seen as “flipping” by some shareholders, but in most plans the participants have been investing for months or longer and are simply reducing their exposure to risk
  - Generally should be made at least a couple of weeks, or even a month, prior to the purchase date. Should not allow for rescinding this election once made
  - Can be structured to allow for the sale of stock during a black-out period, which commonly occur around the same time as ESPP Purchases
- 10b5-1 programs may also be a good idea for reporting officers who participate in the plan

Communication

- Pre-IPO communications are critical to a successful ESPP
- For many employees it will be their first interaction with the stock market
- Bring in experts from the plan design and administration function to explain plan features and mechanics
- Utilize financial and tax advisers who can come in and explain how buying and selling stock works and the basics of income and taxes resulting from the purchase and disposition of shares
- Do not assume that your staff (at any level) understands: the stock market, brokerage accounts, payroll deductions, ordinary income and associated taxes, stock prices, the differences between ESPP and 401(K), the differences between ESPP and any other equity compensation program you may have

Coordinating Your Team



Ongoing Plan Administration

- Good stock administration systems include extensive functionality that can administratively support most or all of the best practices discussed in this presentation
- At smaller companies these plans may be managed by HR, Payroll or someone in the Stock Administration function
- Outsourcing costs are generally reasonable and the firms will do most of the heavy lifting (and late night work) at the time of purchase
- Enrollments are most commonly done via online tools, with hard copy processes to support those with limited internet access
- Ongoing contributions are managed by Payroll, but should be audited and tracked monthly, for planning purposes, by whoever is responsible for the plan
- Terminations must be closely coordinated with HR to manage timing and then followed through with Payroll to manage related refunds

Misc. tips and hints

- Review the calendar before you designate enrollment dates, purchase dates, etc. – what else is happening within your company?
- Consider when employees will be most likely to consider enrolling (after bonus payments, not during holiday shopping season)
- Make it easy to enroll
- Consider a negative consent enrollment
- Reduce the number of decisions – provide a standard enrollment package that can be changed but also easily accepted
- Don't end the enrollment period on a Friday – pick a Monday!

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Questions?

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