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Comp Talks

Design and Administration of Qualified ESPPs

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Now, shall we begin?

1. Key terms & concepts
2. Design alternatives
3. Employee communication
4. Compliance tips & traps
5. Common mistakes & corrections



Key Terms & Concepts

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ESPP Framework

- What does tax qualified mean?
- Offering period
- Offering date/grant date
- Purchase price
- Purchase date
- Equal rights & privileges (ER&P)



Section 423 Requirements

- Certain statutory requirements are inflexible
- Selection among permitted design alternatives impacts accounting and administrative costs
 - Purchase price/discount
 - Length and structure of offerings
 - Eligibility
 - Contribution limits
 - Election changes



Design Alternatives

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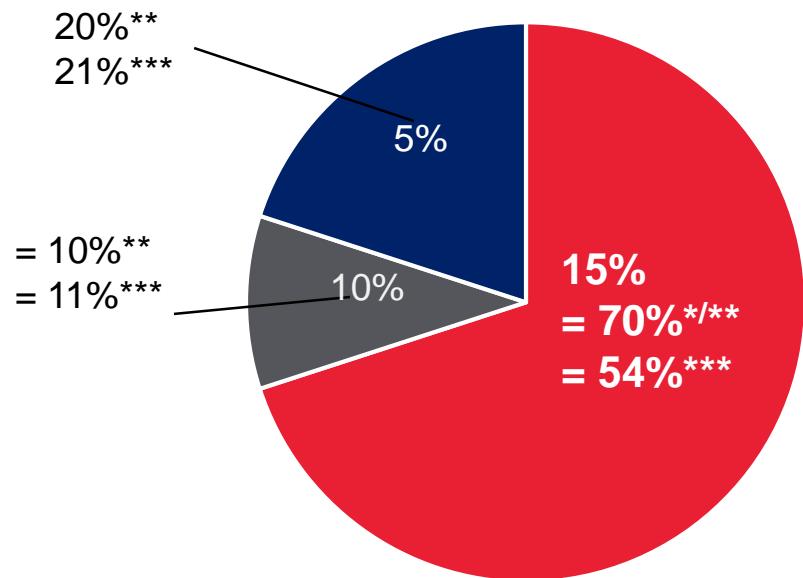
Purchase Price Rules

- Up to 15% discount
- “Look-back” feature permitted
 - Purchase price is lower of the FMV on the offering date (beginning of offering period) or the purchase date (end of purchase period)

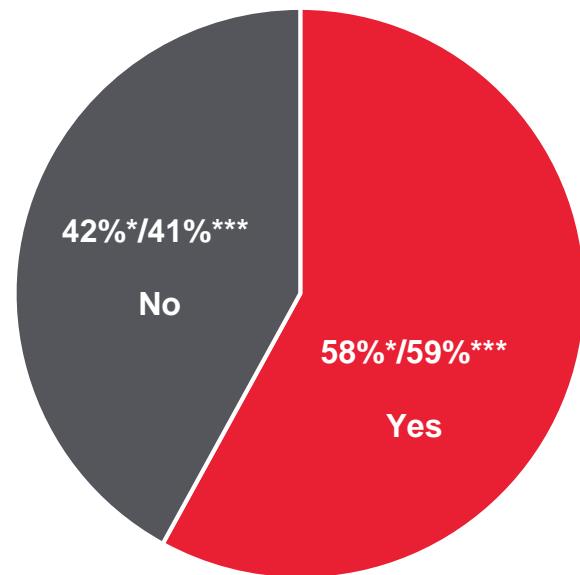


Purchase Price Market Data

Purchase Price Discount



Lookback Feature



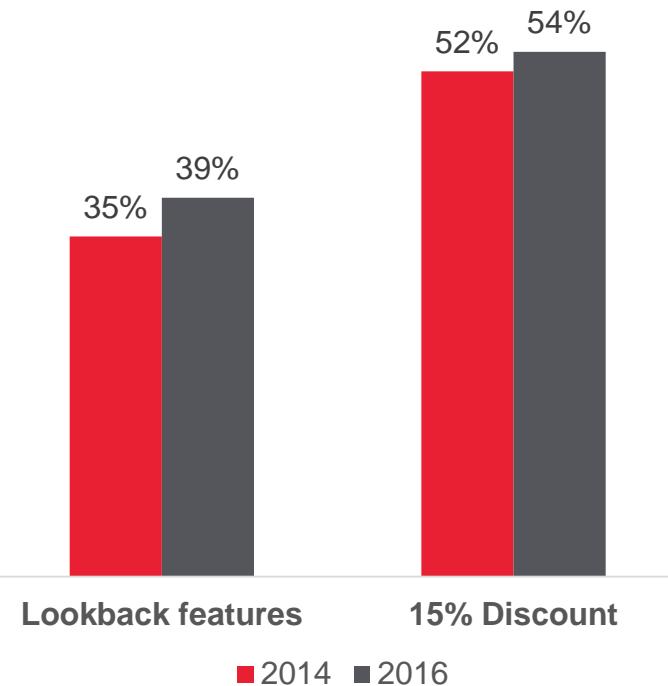
* 2016 NCEO/NASPP/CEPI Employee Stock Purchase Plan Survey

** Ayco Company Updated Survey of ESPPs (Jan 2017)

***Fidelity/Radford 2016 ESPP Data Analysis study



Purchase Price Design Trends



- Slight increase from 2014 to 2016 in ESPP designs including
 - Lookback features: 35% → 39%*
 - 15% discount: 52% → 54%*
- No significant changes in length of offerings

*Fidelity/Radford 2016 ESPP Data Analysis study

Offering Periods & Purchase Dates

- Offering periods
 - Consecutive
 - Overlapping
 - Up to 27 months (if “look-back” feature)
 - Up to 5 years (if no “look-back” feature)
- Purchase dates
 - 6 months most common



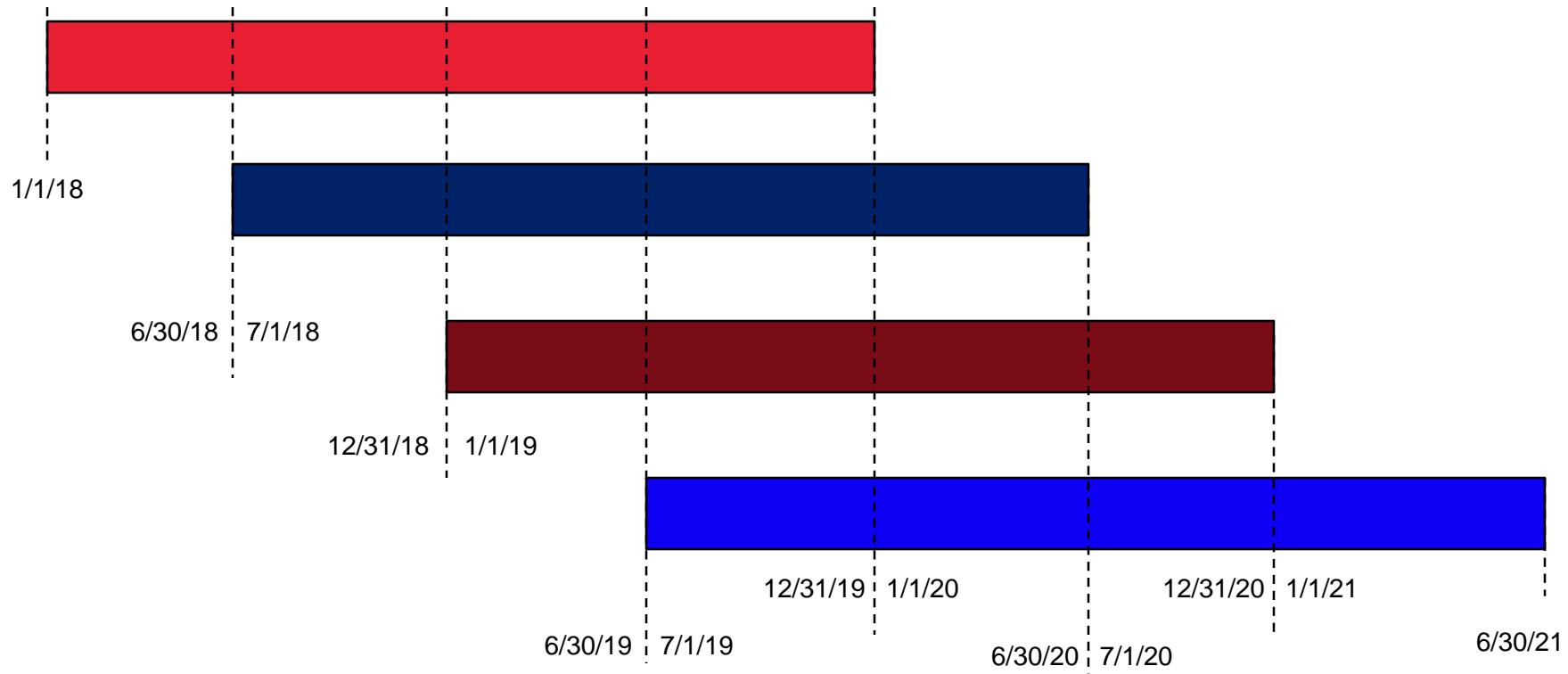
Consecutive Offerings

Offering 1	Offering 2	Offering 3	Offering 4
1/1/18	6/30/18	7/1/18	12/31/18

6 month consecutive offerings with one purchase date

After shares are purchased the offering ends and a new offering starts

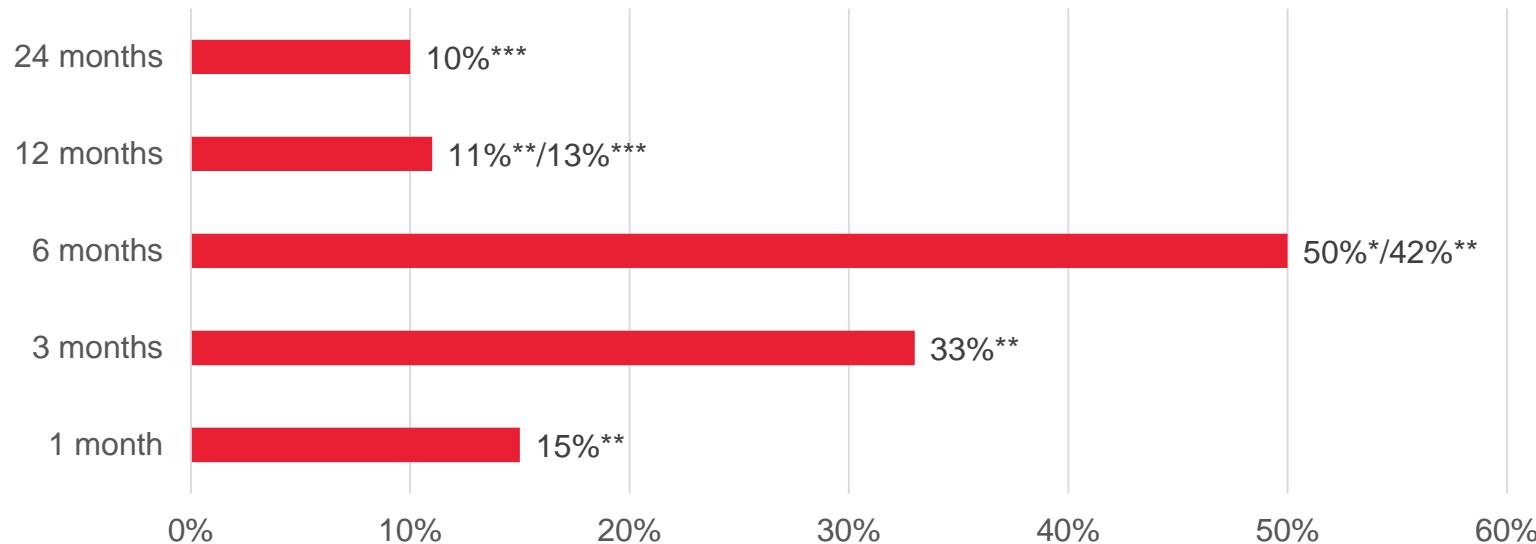
Overlapping Offerings



24 month overlapping offerings with 6 month purchase periods

Offerings & Purchase Periods: Market Data

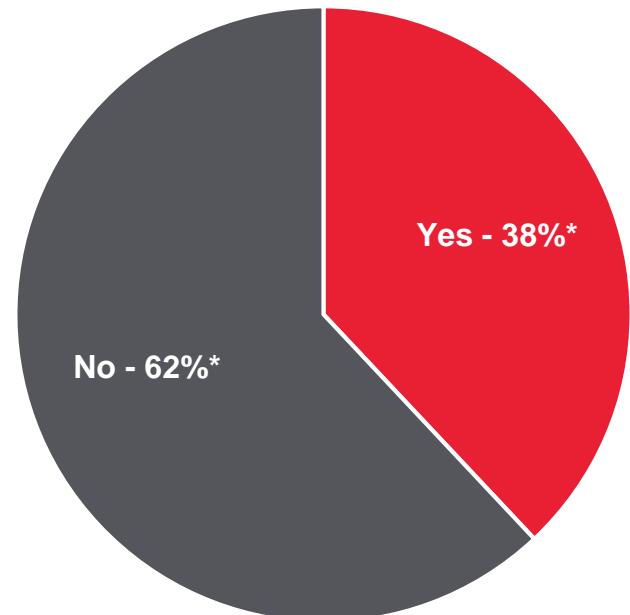
- Length of offerings/purchase periods



- *NASPP/NCEO 2016 Employee Stock Purchase Plan Survey
- **Fidelity/Radford 2016 ESPP Data Analysis study
- ***NASPP 2014 Domestic Stock Plan Survey

Automatic Reset/Rollover Feature

- Possible feature for offerings with multiple purchase periods
- If FMV on purchase date is less than offering date, existing offering ends and new offering starts, with participation elections for terminated offering automatically rolled forward to new offering
 - Increases cost/modification accounting



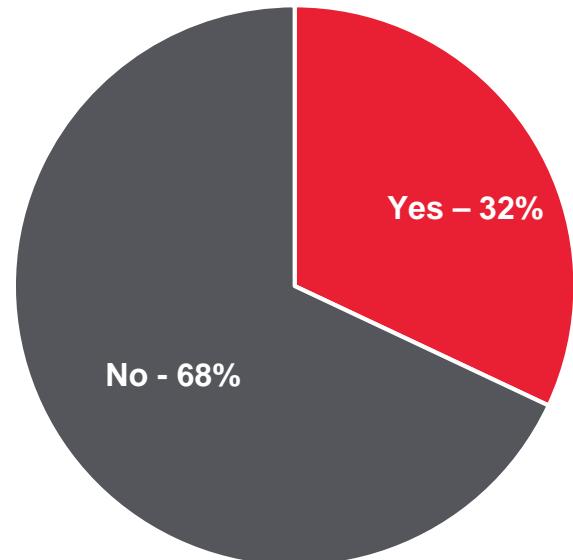
* 2016 NCEO/NASPP/CEPI Employee Stock Purchase Plan Survey

Mid-Offering Adjustments to Contribution Rates



- Remember ER&P
- Can allow upward or downward adjustments during offering or purchase period, as well as withdrawals
- Consider accounting impact and administrative burdens

Mid-Offering Increases Permitted*

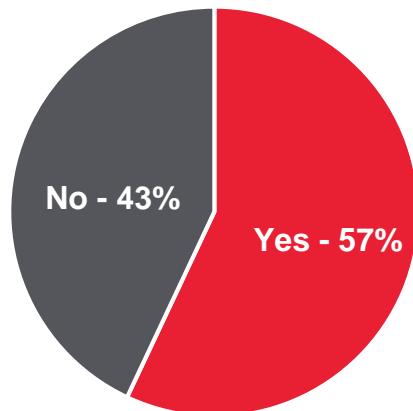


* 2016 NCEO/NASPP/CEPI Employee Stock Purchase Plan Survey

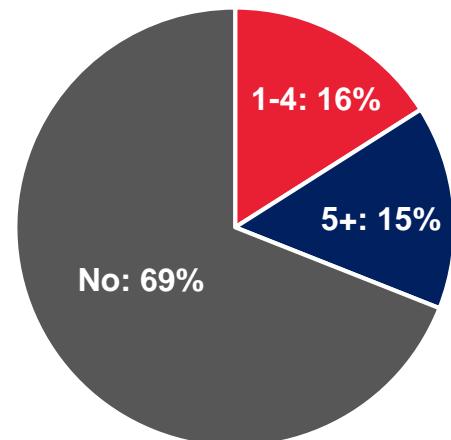
Eligibility Requirements

- Employees only
- Permitted exclusions
 - Part-time
 - Less than 2 years
 - Interns/Seasonal
 - HCEs
- Required exclusions
 - 5% owners

Minimum Hours Required*



Minimum Months Required*



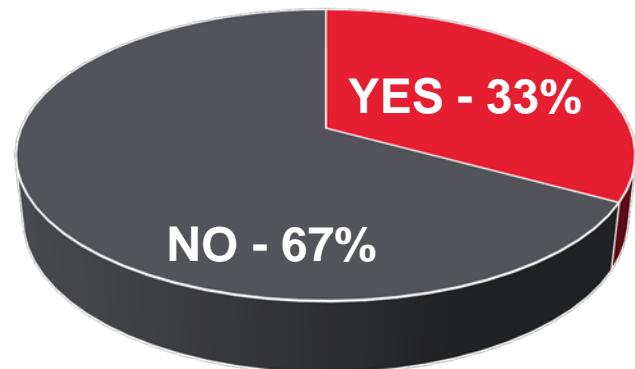
* 2016 NCEO/NASPP/CEPI Employee Stock Purchase Plan Survey

Utilization Statistics

Overall, only about 1/3rd of employees with access to ESPPs actually utilize the benefit (per a recent Fidelity survey)*

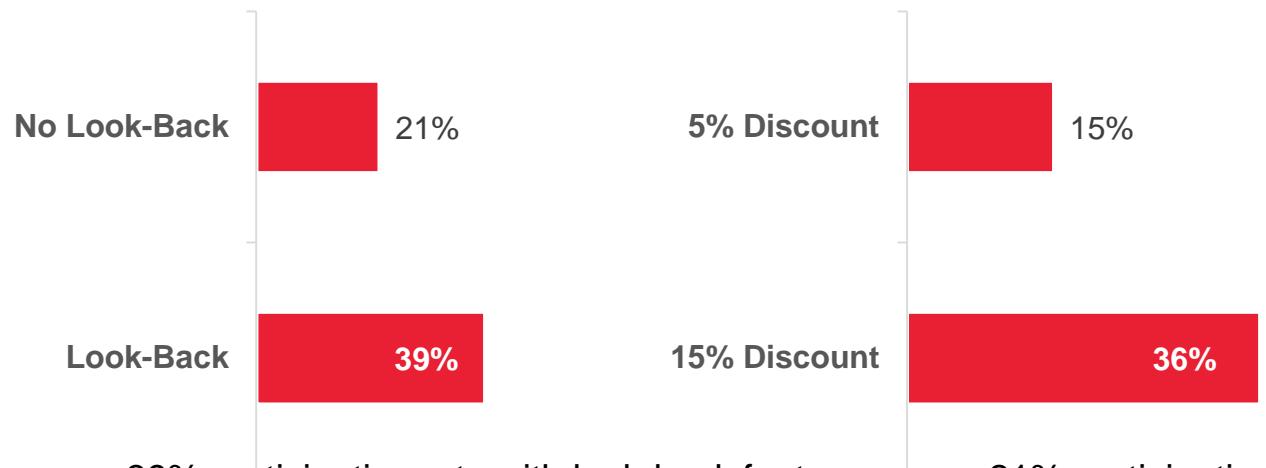


Enrollment



*<https://www.cnbc.com/2016/12/14/employee-stock-purchase-plans-are-underutilized.html>

Design Drives Participation



- 39% participation rate with look-back feature versus 21% participation rate with no look-back*
- 36% participation rate with 15% discount versus 15% participation rate with 5% discount*

*Fidelity/Radford 2016 ESPP Data Analysis study

Medical & BioTech Participation



68% participation rate for offerings with 3 month purchase periods, look-back and 15% discount*

17% participation rate for offerings with 3 month purchase period, no look-back, all discount levels*

*Fidelity/Radford 2016 ESPP Data Analysis study

Technology Participation



50% participation rate for offerings with 6 month purchase periods, look-back and 15% discount*

20% participation rate for offerings with 6 month purchase period, no look-back, all discount levels*

*Fidelity/Radford 2016 ESPP Data Analysis study

Employee Communication

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Going Beyond What's Required

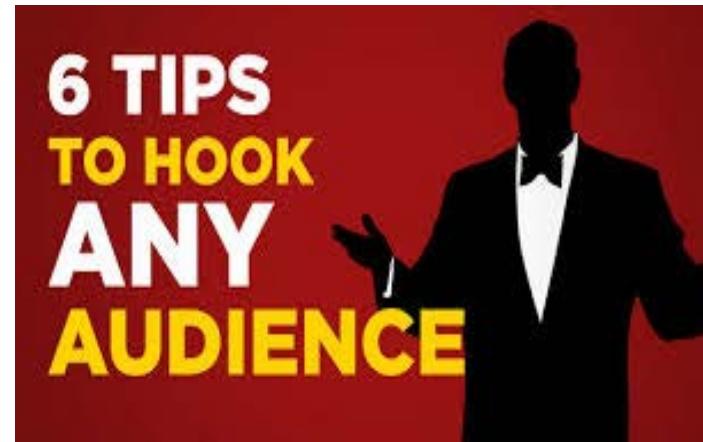


- SEC rules require distribution of prospectus
- Supplement enrollment materials and prospectus with pre-offering communications targeted to specific employee concerns:
 - How can I benefit from participation?
 - How fast will I get my money back?
 - What if the stock price goes down?
 - Any chance I could lose my money?



Communication Tips

- KISS – with legal review
- Use webcasts or other “live” presentations
- Consider using a “panel” with Q&A
- Use PowerPoint slides with graphics/charts
- Give realistic participation examples:
 - Actual scheduled offering and purchase dates
 - Contemporaneous share price
 - Upward and downward price projections, etc.
- Marketing



Focus on What Makes Sense



- For supplemental communications, skip covering enrollment procedures until the end (if at all)
- If enrollment levels are low, focus on economic benefits of participation
- If enrollment levels are good, but plan is complicated and there are lots of questions/choices, (e.g., overlapping offerings) focus on enrollment choices and ways to maximize benefits

Sample Employee Communication

Six month offering with one purchase date, look-back and 15% discount



Price is [lower/higher] on offering date than purchase date.
15% discount is applied to [offering/purchase] date price.
Employee payroll contributions of \$5,000 are used to
purchase _____ shares on purchase date for \$____ per
share when share value is \$____ per share.

Compliance Tips & Traps

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Equal Rights & Privileges



Determination of purchase price, payment provisions **and all other offering terms must be uniform** for each eligible employee within each offering

Trap: Cannot permit special election rights for some employees and not others

- Late enrollment election
- Alternative forms of payment



Participation Caps

OK to include cap on participation that has a uniform relationship to the total or base rate of compensation

- Tip: Don't use total compensation because of difficulty of administration with respect to non-cash compensation and capturing all compensation types in elections
- Trap: Be careful defining "base rate of compensation" so that it does not violate ER&P
 - IRS private letter ruling says OK to include bonuses in "base rate"



\$25,000 Limit

Right to purchase shares cannot accrue at a rate that exceeds \$25,000 per each calendar year in which the offering is outstanding

- Limit applies in the aggregate to all offerings
- The \$25K limit is calculated based on the full FMV of stock on the grant/offering date
- Trap: Tracking gets very complicated and burdensome with participation in multiple overlapping offerings and offerings crossing several calendar years



\$25,000 Limit



- Tip: Once the \$25K limit is reached in a calendar year by a participant, no additional ESPP shares can be purchased during that same calendar year by the participant (even if under a different offering)
- Tip: Unused portions of the annual \$25K limit that accrues may carry forward and be used to purchase shares in subsequent years of the same offering
- Trap: Cannot purchase shares in excess of accrual rate in anticipation that an offering will be in effect for a subsequent calendar year

Eligibility



- Tip: Have internal tracking procedures for any service based eligibility exclusions that may be exceeded
- Trap: May have to give participation rights to employees of foreign subs



Corporations that are “pass-through” tax entities are treated as a single corporation and employees must be given equal participation rights

Common Mistakes & Corrections

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General Principles



- There are no formal correction procedures sanctioned by the IRS for qualified ESPP errors
- By analogy, follow the principles for tax-qualified retirement plan corrections:
 - Restore all parties to same ending place as if the error had not occurred

Excess Purchase

- Too many shares purchased
 - \$25,000 annual purchase limit exceeded
 - Violation of specific IRC requirement
 - ER&P
 - Separate purchase limit exceeded
 - ER&P



Excess Purchase: Time to Unwind

- Put a hold on purchased shares immediately
 - “Unwind” the purchase
 - ▶ Refund the purchase price paid to employee
 - ▶ Employee authorizes the share return
 - ▶ Shares go back to ESPP reserve
 - ▶ Any need to correct prior Form 4 reports on share ownership?



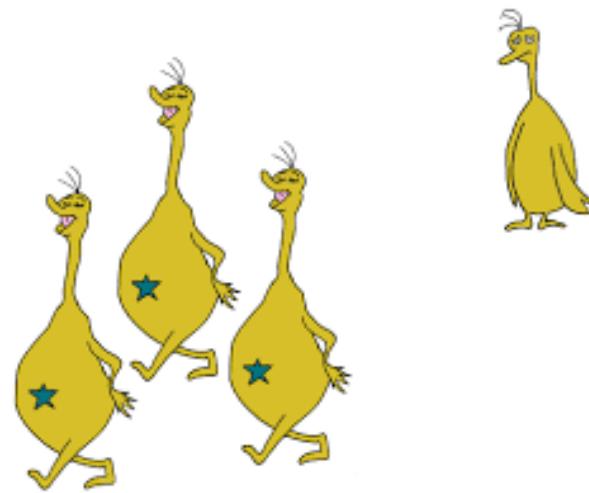
Excess Purchase: Shares Already Sold

- Excess purchase with shares already sold
 - Instead treat as discretionary stock purchase award under equity incentive plan
 - Report as discounted stock purchase (discounted non-qualified option exercise)
 - Requires reduction of discretionary plan reserve
 - Add shares back to ESPP reserve
 - Consider whether board should ratify grant of discretionary award



Mistaken Exclusion

- Mistaken exclusion from participation
 - New hire mistakenly not given enrollment information
 - Part-time or temporary employee (not excluded by plan terms) meet the service requirements
 - Employees of foreign subs which are not separate tax entities



Mistaken Exclusion

- Error discovered prior to purchase date?



- ▶ Provide enrollment materials and allow separate payment rights (e.g., cash/check versus payroll deduction) to allow “catch-up” contribution for prior pay periods
- ▶ Report as qualified ESPP purchase
- ▶ Having a consistent policy to address any individuals affected by same type of error is reasonably defensible and potential violation of ER&P requirements

Mistaken Exclusion

- Error discovered after purchase date?
 - Have participant pay cash/check for shares and treat as purchases that occurred under ESPP on scheduled purchase date for all reporting purposes
 - Have consistent policy for addressing errors (ER&P)



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