



# Comp Talks

## Design and Administration of Qualified ESPPs

Garry Devine, Horizon Pharma plc

Michelle Lara, Cooley

*Moderated by Amy Wood, Cooley*

**Need immediate technical assistance?**

**Leah Lowery**

**858-550-6465**

**llowery@cooley.com**

**Cooley**



# 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

Cooley

# 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

Cooley

# Purchase Price Rules

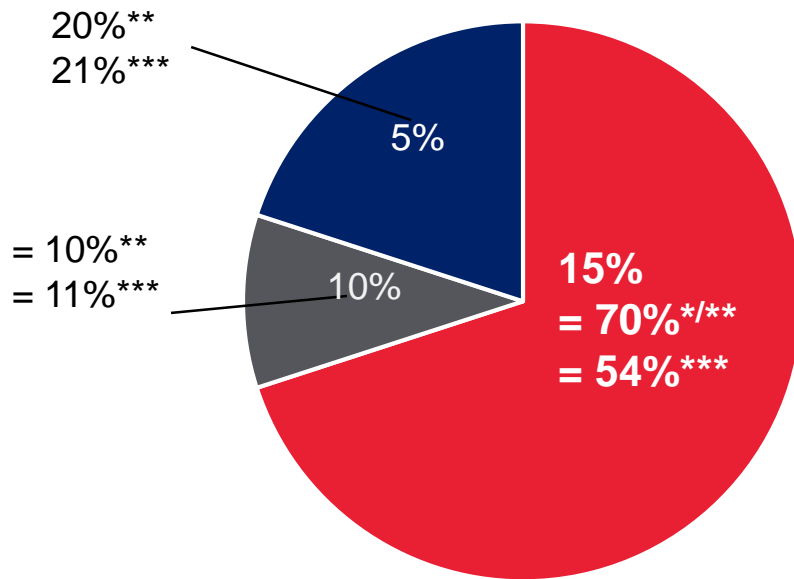
- Up to 15% discount
- “Look-back” feature permitted
  - Purchase price is lower of the FMV on the offering date (beginning of offering period) or the purchase date (end of purchase period)



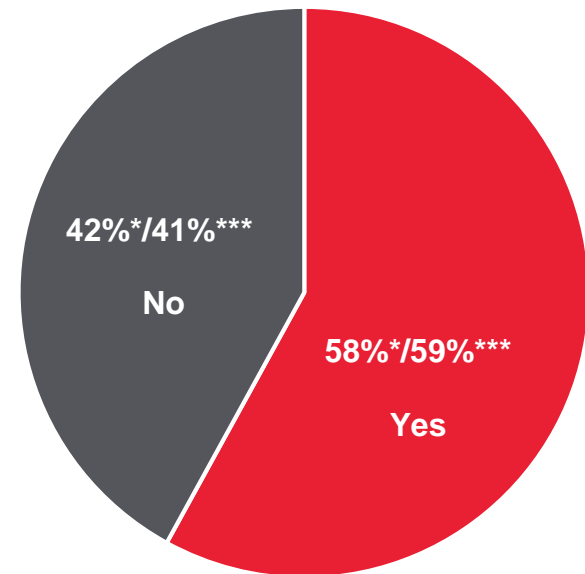


# Purchase Price Market Data

## Purchase Price Discount



## Lookback Feature



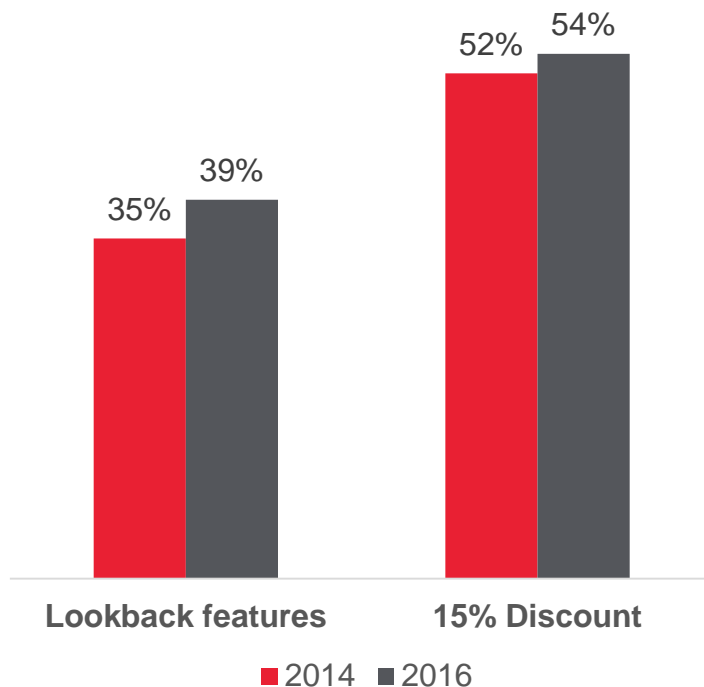
\* 2016 NCEO/NASPP/CEPI Employee Stock Purchase Plan Survey

\*\* 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

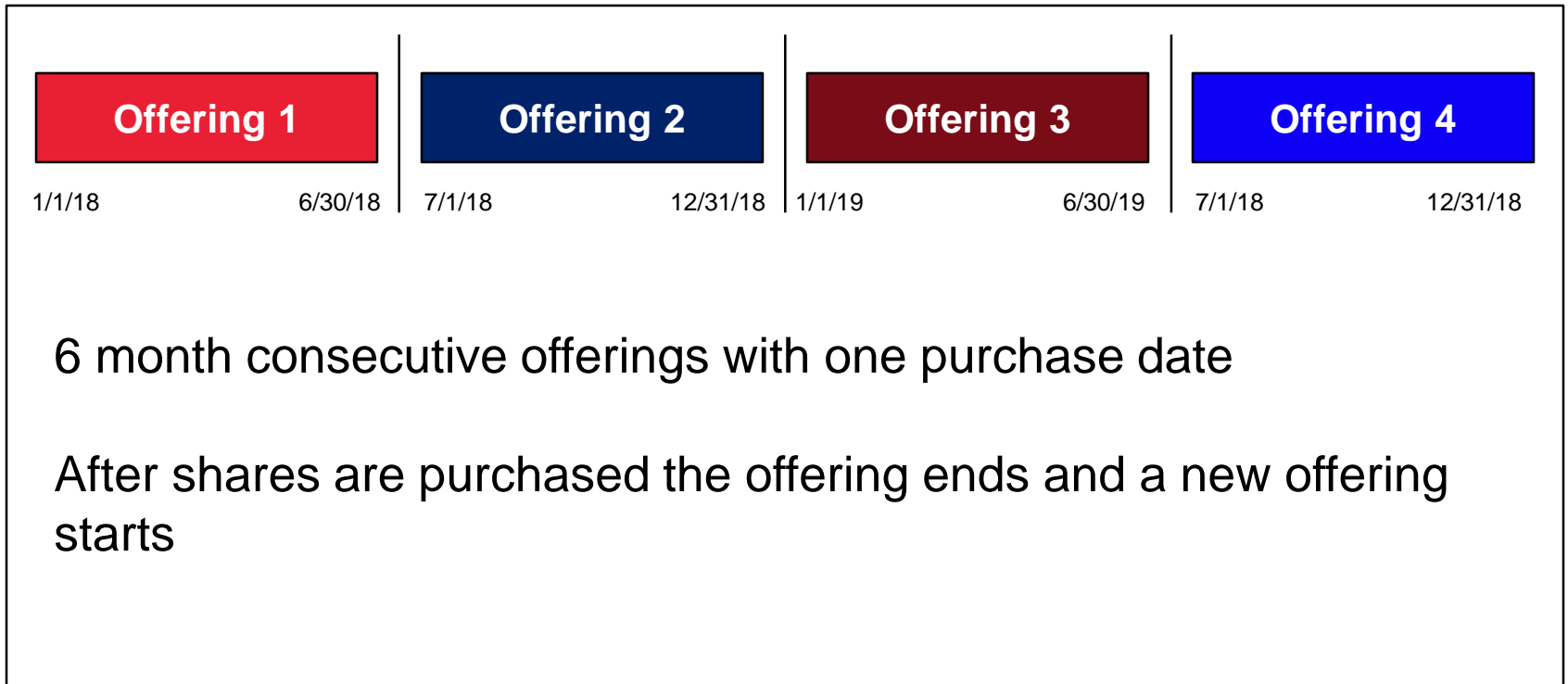
\*Fidelity/Radford 2016 ESPP Data Analysis study

# Offering Periods & Purchase Dates

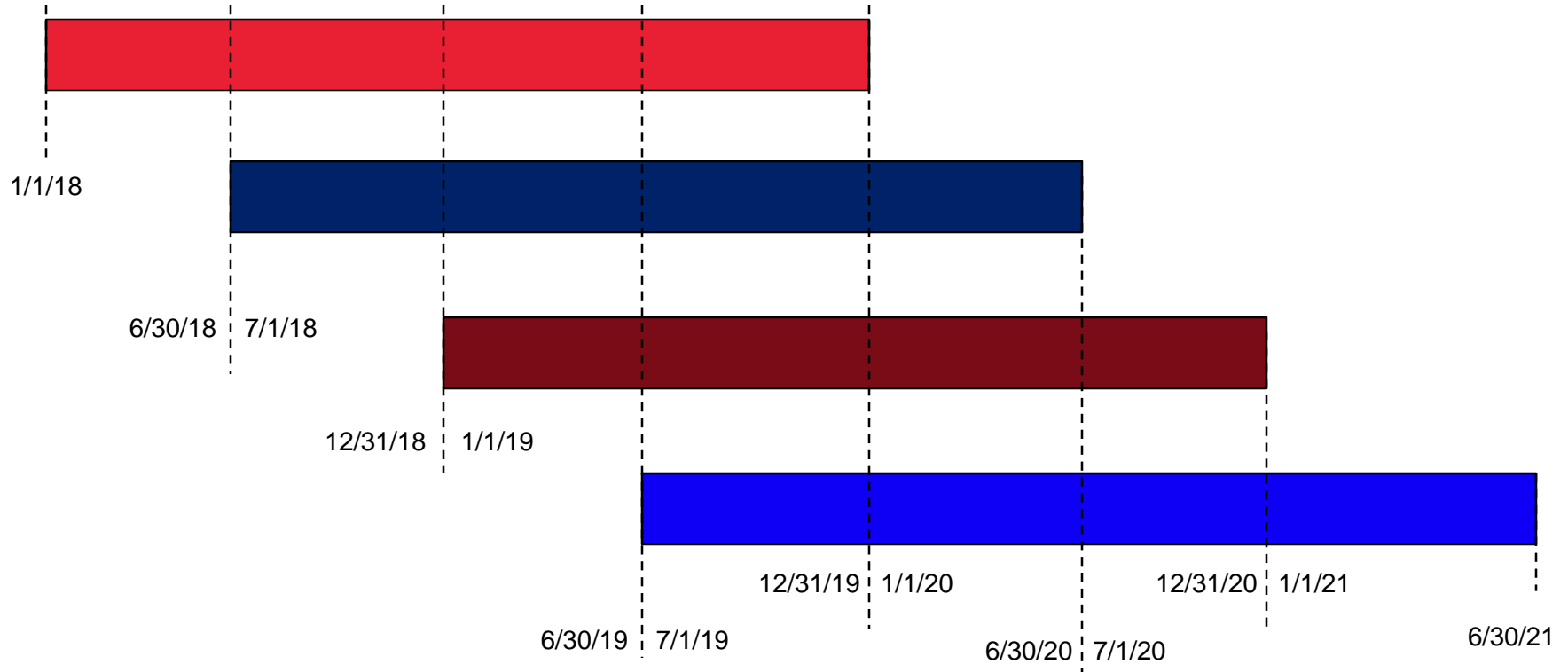
- Offering periods
  - Consecutive
  - Overlapping
  - Up to 27 months (if “look-back” feature)
  - Up to 5 years (if no “look-back” feature)
- Purchase dates
  - 6 months most common



# Consecutive Offerings



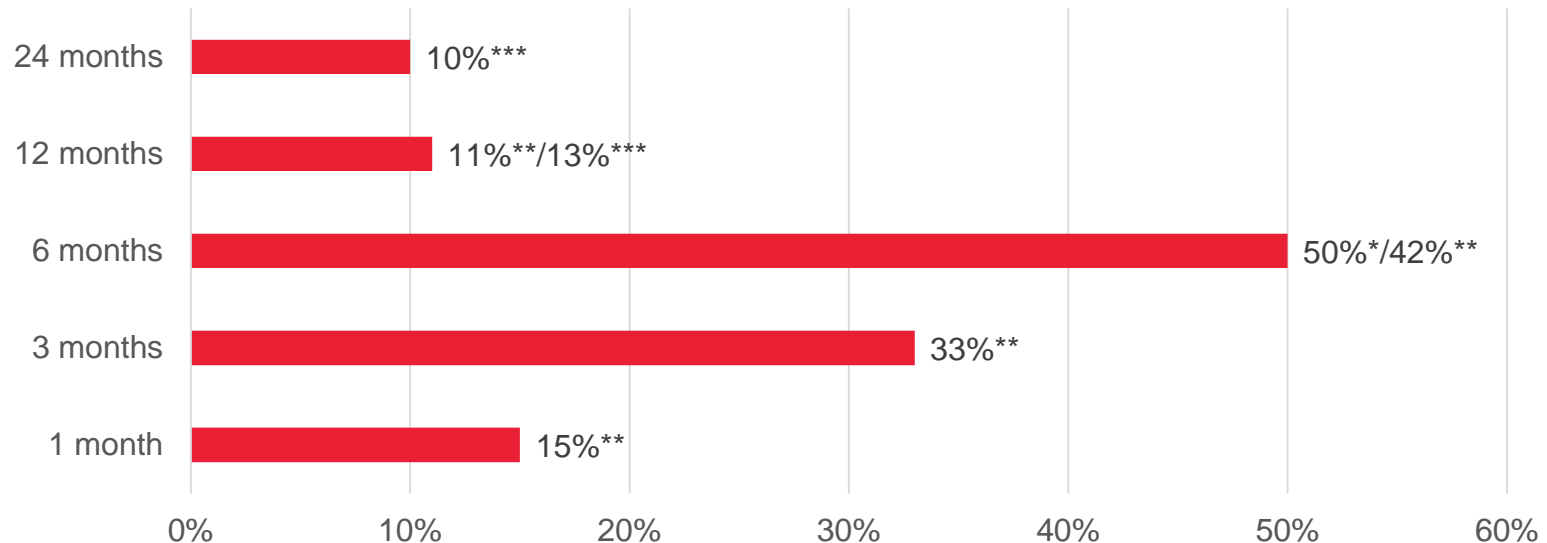
# Overlapping Offerings



24 month overlapping offerings with 6 month purchase periods

# Offerings & Purchase Periods: Market Data

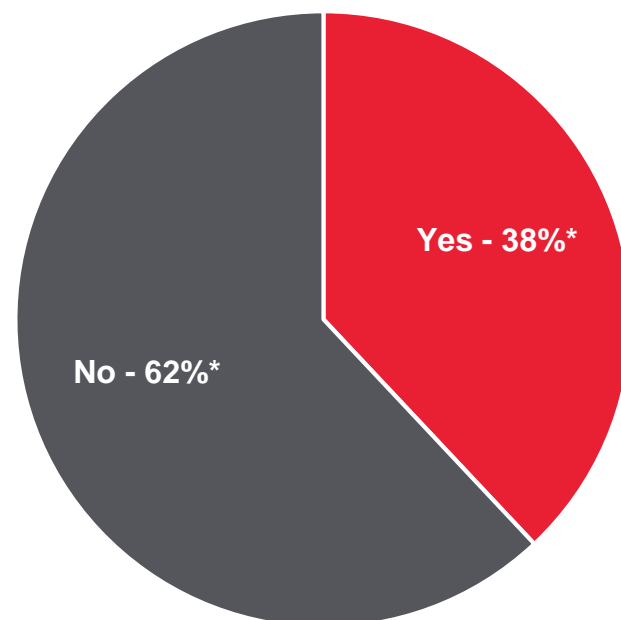
- Length of offerings/purchase periods



- \*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



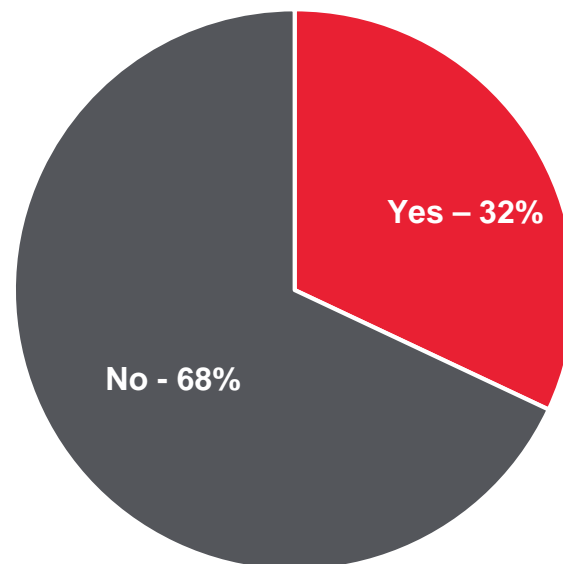
\* 2016 NCEO/NASPP/CEPI Employee Stock Purchase Plan Survey

# 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

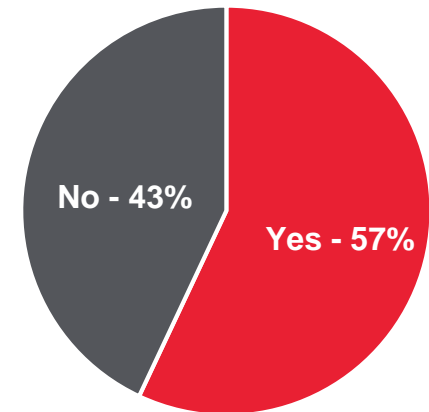


# Eligibility Requirements

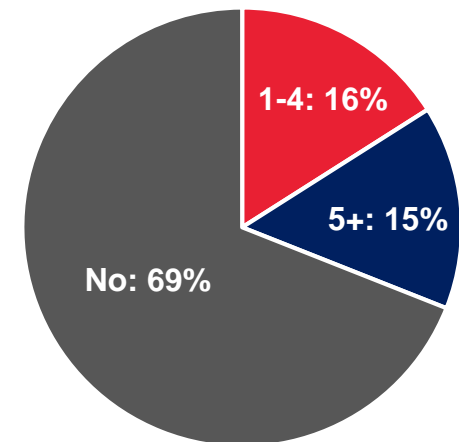
- Employees only
- Permitted exclusions
  - Part-time
  - Less than 2 years
  - Interns/Seasonal
  - HCEs
- Required exclusions
  - 5% owners

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

Minimum Hours Required\*

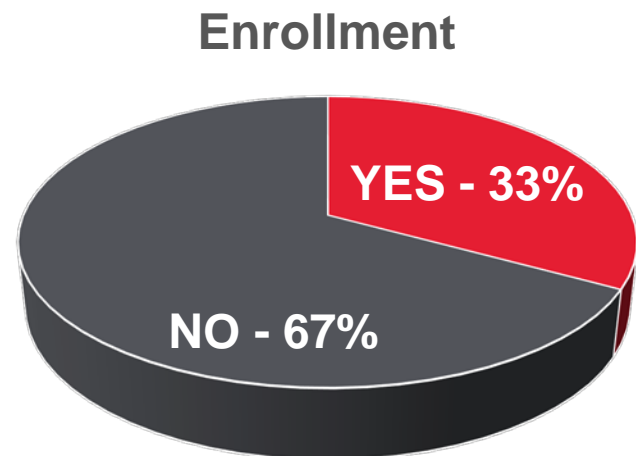


Minimum Months Required\*



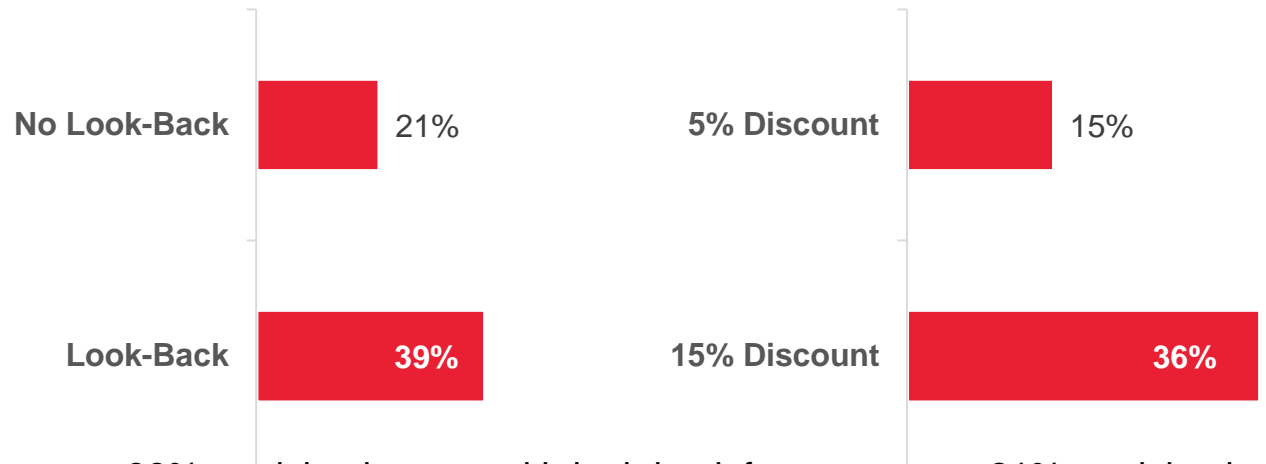
# Utilization Statistics

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



\*<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



**No Look-Back, All Discounts**

17%

**Look-Back, 15% Discount**

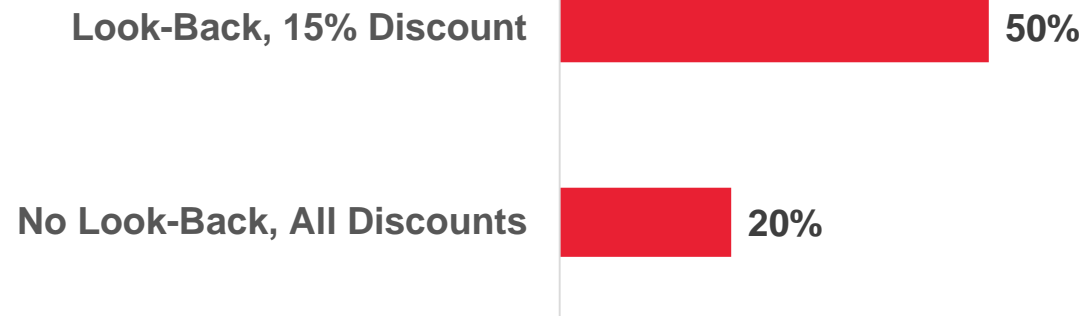
68%

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

Cooley

# 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

Cooley

# 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

Cooley

# 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?



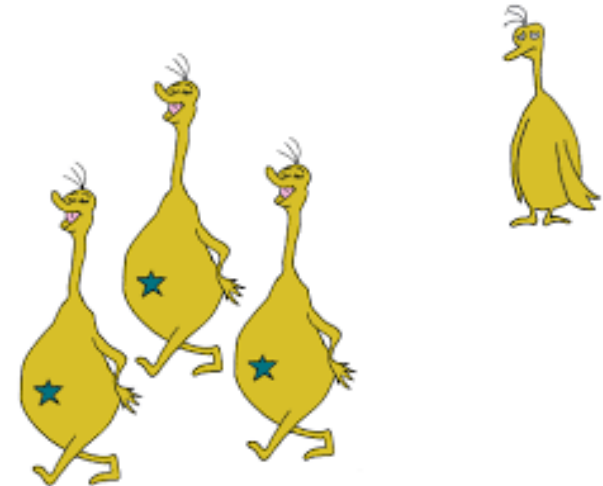
# Excess Purchase: Shares Already Sold

- 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)





**Michelle Lara**

mlara@cooley.com

**Amy Wood**

awood@cooley.com

Cooley

# Comp Talks Webcast Series

Our monthly program addresses hot topics in executive pay and equity compensation.

# Cooley

## Join Us

Keep up with current compensation trends and balance the legal, tax and disclosure requirements and best practices with your practical business needs.

Explore past topics. Find upcoming talks.

[cooley.com/comp-talks](https://cooley.com/comp-talks)