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“Hold ‘Til Retirement” Requirements for Equity Awards: How to Pick and Implement What’s Right for Your Company

A Word from the Publisher

We are devoting much of this issue to a very timely piece on implementing hold ‘til retirement policies for top executives.

In the current environment, we see a real opportunity for companies to make a statement that will resonate with shareholders and employees. Because most CEOs already adhere to a philosophy that the CEO should hold his/her shares for the long term, adopting a policy covering the CEO and NEOs can be quick and simple—yet meaningful. As a result, we expect that many companies and compensation committees will want to do so in time for this year’s upcoming proxy statements. (We can see institutional investors pushing for HTR policies this proxy season; here is an opportunity for many companies to get ahead of this one at very little cost.)

[Another feature which dovetails nicely with hold ‘til retirement—because it eliminates the need for executives to sell shares into the open market to pay for the exercise of stock options—is the *net exercise*. Anyone who missed the March-April 2008 issue of *The Corporate Executive* which was devoted to “Everything You Need to Know About Implementing Net Exercises” will want to read that excellent issue. Don’t overlook the workshop on net exercises at the upcoming NASPP Conference.]

Lastly, we round out this issue with some ESPP developments and with a few important heads-ups on pages 11–12.

—JMB

A number of leading companies require their executives to keep a substantial part of the stock awards they earn for the duration of their career. These companies boast a variety of benefits, including aligning executives and shareholders, encouraging long-term focus, fostering a company-wide ownership culture and providing a continuing and growing personal incentive to work towards superior stock performance. Institutional investors note that these requirements help to alleviate concerns raised by recent scandals relating to the timing of option exercises and stock sales by senior executives, as well as by the general increase in the size of equity compensation awards over the past 20 years.

Notwithstanding the benefits, only a minority of companies have true “hold ‘til retirement” (HTR) requirements. By our count, there are now close to 40 companies that have hold ‘til retirement requirements. On the other hand, at least two-thirds of S&P companies have some form of traditional stock ownership guideline, whereby executives are required to acquire and retain a certain value of company stock (usually a multiple of salary).

Given the continuing focus on stock ownership and some of the weaknesses of more traditional stock ownership guidelines, we think that the time is right for more boards to consider HTR requirements. [For more on the need for companies to reassess their stock ownership guidelines, see the Winter 2008 issue of *Compensation Standards* at pg 4.]

We will first outline some of the different forms HTR requirements take, describe their



2 benefits and explore steps that can be taken to address criticisms. We conclude with a step-by-step guide on how to pick the HTR requirement that is right for your company and how to implement it.

Forms of HTR Requirements

Boards can choose from multiple designs to implement HTR requirements. We have divided them into three categories: (1) retention ratios, (2) long-term vesting and (3) temporary requirements in conjunction with traditional stock ownership guidelines.

Retention Ratios

The typical HTR requirement is the “retention ratio,” which establishes a percentage of earned equity awards that must be retained until the executive leaves the company. Whenever the executive receives a share from a company stock plan, such as when a stock option is exercised or when shares are vested under a restricted stock grant, a portion of the net shares received must be retained for the duration of the executive’s career with the company.

These requirements apply to awards that have already been earned, so the executive is not in danger of losing the awards on leaving the company. Rather, the executive simply is required to continue to hold the shares after he has already satisfied the relevant service vesting and/or performance vesting requirements. In addition, in this typical design the retention ratio applies only to so-called “profit” or “gain” shares that remain after payment of taxes and, in the case of stock options, the exercise price.

For example, JPMorgan Chase generally requires its CEO and each member of its management committee to retain 75% of the net shares of stock received from equity awards after deductions for taxes and exercise prices. In the case of an award of 100 restricted shares, on vesting about 50 shares would go to taxes and a little more than 35 (or 75% of 50 after-tax shares) would be required to be held by the executive until retirement. Fifteen shares would be available to the executive to satisfy current needs or to diversify.

In contrast, typical stock ownership guidelines generally require an executive to acquire a certain

fixed value of company stock, usually expressed as a multiple of salary, within a fixed period of time. For example, a CEO with a \$1 million salary and an ownership guideline of five times salary would be expected to maintain ownership of shares with a value of \$5 million.

Long-Term Vesting

Under the long-term vesting design (which is particularly well suited for restricted stock and RSUs), some percentage of an executive’s equity award does not vest (that is, the executive does not become entitled to receive it) until normal retirement. Therefore, not only can the executive not sell or exercise these awards until retirement, but they will be forfeited if the executive leaves before retirement age.

ExxonMobil is one major company that employs this design. It divides stock grants to its executives into two parts: One half vests after five years, and one half vests only on the *later* of normal retirement and 10 years after grant. Thus, an executive must hold this second half for at least 10 years after grant, even if the executive retires before that time.

Temporary (With Traditional Guidelines)

Some companies implement holding requirements only until traditional stock ownership guidelines have been met. Bristol-Myers Squibb, for example, requires its most senior executives to retain all of their profit shares until the executive satisfies the stock ownership guideline. At that time, the executive is required to retain 75% of any excess profit shares for one year following vesting or exercise.

These temporary designs provide a means for executives to achieve designated stock ownership levels. Their benefits, however, are really tied to the benefits of traditional stock guidelines themselves. We believe, however, that true hold until retirement retention ratios, which are compatible with traditional stock ownership guidelines, can provide substantial additional benefits.

Real-Life Examples

Once a board has selected any of the basic designs, there are still a number of variables. The following table provides some examples of the variety of designs currently employed.

| Company | Design | Formula | Equity Awards Subject | Executives Subject |
|----------------------|-------------------|---|---|--|
| Bristol-Myers Squibb | Temporary | 100% until stock ownership guideline met | All equity awarded, net of taxes and exercise price | Executive officers |
| Citigroup | Retention Ratio | 75%, 50% or 25% of shares, depending on seniority | All equity awarded, net of taxes and exercise price | 75% for Executive Committee (16 people), 50% for Senior Leadership Committee (39 people) and 25% for other "senior management" |
| ExxonMobil | Long-term Vesting | 50% of stock awards restricted for 10 years or until retirement, whichever is later | All restricted stock awards (ExxonMobil has not issued options since 2000) | "Most senior executives," including all named executive officers |
| FPL Group | Retention Ratio | 66% of shares Also has traditional stock ownership guideline | All equity awarded, net of taxes and exercise price, after becoming subject to the policy | Executive officers |
| Goldman Sachs | Retention Ratio | 75% or 25% of shares, depending on seniority | All equity awarded (other than IPO awards made in 1999), net of taxes and exercise price | 75% for CEO, CFO, COO and Vice Chairmen, and 25% for Participating Managing Directors (about 300 people) |
| JPMorgan Chase | Retention Ratio | 75% of shares | All equity awarded (other than 2007 awards, to the extent exceeding 50% of incentive compensation), net of taxes and exercise price | Management committee (48 people) |
| Merrill Lynch | Retention Ratio | 75% of value Also has traditional stock ownership guideline | All equity awards, net of taxes and exercise price | Executive officers and other designated members of senior management |
| Morgan Stanley | Retention Ratio | 75% of shares | All equity held at time executive becomes subject (whether or not received from awards) and all equity awards thereafter, net of taxes and exercise price | Management Committee (about 15 people) |
| Synovus | Retention Ratio | 50% of shares Also has traditional stock ownership guideline | All equity awards, net of taxes and exercise price | Executive officers |
| Wachovia | Retention Ratio | 75% of shares Also has traditional stock ownership guideline | All equity awards, net of taxes and exercise price | Executive officers |
| Wells Fargo | Retention Ratio | 50% of options | Options exercised, net of taxes and exercise price | Executive officers |

4 Reasons to Adopt

HTR requirements strongly support executive stock ownership, emphasize long-term performance of the company's stock, balance increases in equity award size by ensuring increasing executive ownership and can help restore investor confidence. HTRs also possess significant advantages over traditional stock ownership guidelines. Each of the above is a significant reason for boards to consider HTR requirements now.

Strongly supports executive stock ownership

Executive stock ownership has long been called the cornerstone of good corporate governance. HTR requirements provide an effective, manageable and visible way for the continuous stock accumulation by executives over the course of their entire careers.

Emphasize long-term performance

With a typical HTR design and annual equity grants, the number of shares of company stock that an executive is required to retain increases each year. As a result, it is assured that an executive will continue to build exposure to long-term company performance notwithstanding any short-term changes in the value of shares. This type of guaranteed, increasing exposure strongly aligns the long-term interests of executives with those of other shareholders.

We believe that the emphasis on long-term performance is one reason that many investment banking firms have adopted HTR requirements. These firms emphasize annual compensation and generally do not make extensive use of multi-year performance plans. HTR requirements provide an appropriate balance to this type of compensation design.

Balance increased size of equity awards

As the size of equity awards and the resulting accumulated wealth of executives has increased over the past 20 years, many institutional investors and respected advisors have noted that there often has not been a corresponding increase in executive stock ownership levels. An HTR requirement ensures that any dilution resulting from equity compensation is counterbalanced by increasing executive ownership and alignment.

For this reason, a number of institutional investors, such as the American Federation of State, County and Municipal Employees, have

introduced shareholder proposals supporting HTR requirements. In addition, Riskmetrics's Corporate Governance Quotient (CGQ) positively rewards companies that have holding periods relating to a meaningful portion of shares acquired on the exercise of stock options or vesting of restricted stock (although specific percentages or periods are not disclosed). Compensation practices account for 30% of a company's CGQ.

Restore investor confidence

Executives profiting through the exercise of options and/or sale of stock at the expense of outside investors has been a repeating feature of the corporate frauds over the past decade. HTR requirements strongly counterbalance any perception that executives can inappropriately time market sales. A number of business groups, such as the Conference Board Commission on Public Trust and Private Enterprise, the Business Roundtable and the National Association of Corporate Directors have introduced best practice initiatives endorsing additional executive stock ownership and holding requirements.

Investors and the public at large have become exercised over the huge amounts of wealth that even "caretaker" CEOs have received through equity grants with no "strings" attached. A company's adoption of an HTR sends a great message to investors—and helps restore the public's trust in the integrity of the system—that the CEO and top executives are tied to the company's performance (through ups and downs) for the long term.

Advantages Over Traditional Stock Ownership Guidelines

Traditional stock ownership guidelines also provide a path to executive stock ownership. However, guidelines are relatively fixed as to the value of stock required to be owned, which has a number of important consequences. First, for executives who may receive annual equity awards valued at a multiple of their base salaries, or who otherwise work at the company for many years, guidelines may lose effectiveness as a means of promoting increased ownership and/or ensuring that a substantial portion of the executive's net worth is represented by company stock. This is especially true during periods of rising stock prices. (As a company's share price increases, the number of shares an executive is required to retain actually falls.)

Second, as a consequence of the fixed nature of traditional stock ownership guidelines, guidelines also face pressure during periods of declining stock prices. When share prices fall, executives must either purchase additional shares, which may be difficult if market declines are associated with an otherwise difficult economic environment, or the company must relax enforcement, which can lead to criticism at exactly the time investors would want to see executive commitment to the company. Traditional guidelines can also impose unequal burdens on executives, particularly between long-tenured employees (who may have satisfied the guidelines long ago) and new hires (who may have to, or may feel obligated to, devote a large portion of current income toward satisfying the guidelines).

HTR provisions are dynamic and can address each of these potential issues. Moreover, operating a continuing HTR requirement in tandem with a traditional ownership guideline can provide for an executive ownership and retention program that is both robust and fair. As one possibility, top executives could be required to retain 100% of any profit shares until the ownership guidelines were satisfied, and then could be required to retain a smaller percentage, such as 75% of any profit shares acquired after that time. A program such as this one sends a message that executives are expected to exceed stock ownership guidelines as they become more senior and provides a mechanism for achieving stock ownership that is both fair to new hires and operates “automatically” during times of decreasing stock prices.

Addressing Potential Criticisms

HTR designs, if not designed with care, can have potential drawbacks and unintended consequences. The primary criticisms of HTR requirements are that such requirements could encourage executives to leave and that they may not be “competitive.”

Do the requirements encourage executives to leave?

HTR requirements (and strict stock ownership guidelines) are sometimes said to encourage executives to leave their companies. Because most shares can be sold only after employment ceases, an executive arguably has an incentive to leave to realize prior earnings.

There are a number of approaches that can address this concern. First, the company can set the holding period at the *later* of retirement or age 65 (or 10 years from grant).

A company may also want to use the tandem approach described above, which involves traditional stock ownership guidelines plus a reduced retention ratio after satisfying that guideline. For executives at levels beneath the top executive level, a reduced retention ratio (say, 50 or 60%) could operate to limit the perceived burden of the HTR requirement after an executive has achieved a meaningful stake in the company. We believe that this can be an effective approach that has seen only limited use so far. Companies may consider scaling back the retention ratio on an executive’s becoming eligible for early retirement. FPL Group uses a similar approach, eliminating the holding requirement when an executive reaches age 60.

The ExxonMobil long-term vesting approach (the *later* of retirement or 10 years from grant) combines the concepts of stock retention and employee retention and strongly addresses the concern of employee turnover. It also helps address and justify a compensation committee’s decision to continue making grants in the years leading to a CEO’s retirement.

Are HTR requirements “competitive”?

We strongly believe that typical HTR requirements can be competitive if targeted at the appropriate executive population and successfully presented as providing strong corporate governance and shareholder alignment. In particular, an HTR requirement may not represent a marked departure from the status quo for many executives. For example, in our experience CEOs only rarely sell during their tenure. Establishing a retention ratio for many CEOs would represent a public affirmation of an existing moral commitment at little additional cost. This CEO retention ratio could be paired with reduced retention ratios for the next management tier. We believe that such a combined approach would achieve most of the benefits we have described with limited competitive cost.

Adopting such designs—at least for CEOs and NEOs—in the current environment can send a powerful message not only to the public, but internally throughout the company.

6 *Not appropriate for some?*

Companies must consider their *complete* compensation program when evaluating HTR requirements. For a company that has a significant long-term compensation program, with multi-year performance- and/or service-based vesting periods, and a rigorous stock ownership guideline, adding HTR requirements may seem at first blush to be overkill. When viewed, however, from the perspective of shareholders and corporate governance—and in view of the substantial amounts that are now being delivered to top executives through equity awards—HTR requirements are an important ingredient. (Of course, for a company that has limited equity compensation or provides below-median compensation, HTR requirements may not be appropriate.)

It should be kept in mind, however, that HTR requirements are most appropriate only for executive officers rather than lower tiers of management. [We very much like the idea of graduated retention ratio tiers as an executive makes his/her way up the higher executive ranks. In this way, the executive can take pride in achieving the next level, with the greater responsibility to shareholders it also entails.]

We expect that many companies would benefit from incorporating HTR requirements into their compensation programs. With retention ratios, these programs appropriately balance the goals of shareholders and executives.

Ten Steps to Designing the Program That Is Right for You:

1. Decide on the type of design. We believe the retention ratio offers the most benefits with the least cost. [But also see our discussion below on ExxonMobil's retention design, which we especially commend to those companies that award restricted stock.] In addition, if a company is considering requirements for specific new-hire or retention awards, long-term vesting may also be an appropriate choice.
2. Pick who will be subject. The most common choice is to include a company's top executives. Alternatives include covering a management committee or, perhaps (at lower retention levels) additional management tiers.

This is the area where there is probably the most flexibility, depending on what a

company wants to achieve. A company can make a substantial statement by covering only its CEO, particularly in light of the disparity between the compensation of the CEO and the remainder of the executive team at many companies. On the other hand, layered retention requirements that go deeper into an organization could be used to foster a company-wide ownership culture (particularly for companies that make extensive use of equity grants).

3. Set retention ratios. The most common retention ratio is 75% of profit shares. Companies should also consider combining this type of retention requirement with a traditional stock ownership guideline. (A hybrid requirement for executives to retain a higher percentage until the ownership guidelines are satisfied may be appropriate.)

Most companies base HTR requirements on the number of profit shares, but there are examples that base HTR requirements on share value (giving credit for in-the-money, but unexercised, options). In our view, a share-number approach would be consistent with more compensation programs.

4. Decide which shares will be covered. For CEOs and the top level of executives, all outstanding award shares should be included. We are big fans of the approach that many of the savvy companies with HTRs have taken: the CEO commits all his outstanding award shares—including previously vested restricted stock and currently held shares from previous option exercises. He then asks the top tier of executives to make the same commitment. We understand that this approach has worked well in practice. It sends the right message (internally and externally).

If lower tiers are included, we believe that the most straightforward approach is to cover all equity awards, beginning with any awards that are currently outstanding but unvested at the time an executive becomes subject to the HTR requirement (or even only new grants going forward). This type of requirement is less likely to require change as grant programs mature and is fair to employees who may have had expectations of realizing the value of previously earned and vested shares before becoming subject to the requirement.

Some companies use HTR requirements that cover only one type of grant, such as options. Others cover all shares owned by an executive at the relevant time, including shares previously earned and vested and shares purchased in the open market. A company may also want to consider whether an HTR requirement should apply to any special or nonstandard grants that may be made outside the company's normal incentive compensation program.

5. Consider exceptions. Common exceptions from an HTR requirement include shares pledged to charity, certain estate planning transfers (possibly depending on the continuity of beneficial ownership) and economic hardship. Companies should decide what exceptions apply and who will have to approve them; the latter may be different for executives under the purview of the compensation committee and other employees.

As we have mentioned, companies may also want to consider relaxing the retention ratio when an executive reaches regular or early retirement age. This type of feature may go a long way toward addressing potential downsides of HTR requirements.

6. Be sure to include anti-hedging provisions. If employees subject to a share retention policy can hedge their shares, the purpose of the policy is defeated. A company should be sure to address this issue in drafting and implementing its policy. [For more on anti-hedging policies, see the September-October 2002 issue of *The Corporate Counsel* at pg 8.]
7. Document the requirement and consider enforcement. Most companies implement HTR requirements through a policy adopted by the board. Adopting a policy tends to be simple, in that it does not require the consent of any specific executive, and is also a straightforward way of covering awards that are outstanding and/or previously acquired shares.

Companies that take the policy approach will need to consider enforcement. Almost all policies act as a form of moral commitment. For example, Citigroup refers to its holding requirement as a "blood oath." Some policies provide that a violation will be considered in making future awards. Depending on the provisions of an applicable

employment agreement or the equity awards themselves, a policy violation could result in cessation of future grants or even be "cause" for termination. If a company is thinking about enforcing an HTR requirement for some period after an executive's departure, having an enforcement mechanism may be particularly important.

Alternatives to a policy-based approach would be to include the requirements in the award agreements themselves, which may be particularly effective if the executive is required to countersign the award, or to require separate share ownership agreements. Goldman Sachs has used separate share ownership agreements since its initial public offering. [We have posted on CompensationStandards.com Goldman Sachs', ExxonMobil's and Total System Services' agreements.]

8. Don't forget to focus on your SEC filings, etc. We asked former SEC Chief Counsel, David Lynn, what his take is on whether a company has any filing obligations when it adopts an HTR policy. Here's his response:

"I don't think that policies of this sort get picked up by Item 601(b)(10)(iii) of Reg. S-K as a compensatory plan, contract or arrangement, so I don't really think that they must be filed as an exhibit to a periodic report. Perhaps the best approach is to announce the adoption of the policy in a Form 8-K and file the policy as an exhibit 99.1 to the 8-K. I would also say that the company should post the policy in the corporate governance portion of its website, where I think it is more likely to get noticed than as an exhibit to an SEC report." [We have posted on CompensationStandards.com the JPMorgan Chase Form 8-K with the letter to all employees that announced their HTR policy as an exhibit 99.1.]

9. A Press Release. To follow on David Lynn's suggestion about posting your HTR policy on your company website (and in addition to your proxy disclosure and an 8-K filing), we think that companies should take advantage of this opportunity to trumpet this responsible corporate governance/shareholder friendly move by issuing a press release. (Readers may wish to borrow from the best of the internal communications and proxy disclosures posted on CompensationStandards.com.)

- 8 10. Excellent Source of Documents. We have made a number of references to the HTR materials we have posted on CompensationStandards.com that should make it much easier for our readers to implement HTRs without reinventing the wheel. We ask that readers share with us all your HTR documents (including your press releases and website postings) as well as suggestions, pointers and interesting features that we will continue to post so that we may all benefit from each others' experiences.

An Additional Comment on ExxonMobil's Approach

We must confess that we had not been aware of ExxonMobil's "retirement or 10 years after grant—whichever is later" approach until we started preparing for this piece. (As an aside, here is an example—and a heads up for investor relations officers—of how a corporate press release could have generated more investor goodwill.) The more we have examined it, the more we like it.

To recap, 50% of each restricted stock grant made to a top executive vests over 5 years (*i.e.*, typical vesting) but the other 50% does not vest until the later of retirement or 10 years from grant. Note that you don't have to be employed, you just can't receive the shares or enjoy their fruits until 10 years from the date of grant. ExxonMobil feels very strongly that the purpose of its grants is to motivate actions and decisions by the recipients that are in the company's best long-term interests. [Note also that 50% of the total grant is essentially the equivalent of 75% of the profit shares after taxes.]

We like the 10-year horizon—particularly for executives who are approaching retirement. We think that the ExxonMobil approach has application beyond restricted stock to stock options and other forms of long-term incentive compensation. It puts "long-term" back into what we all call "long-term incentive compensation." It sends a great message to shareholders. We would like to hear from readers that adopt this laudable, responsible approach.

Go to It!

HTR requirements provide an easily visible symbol of executive and board commitment. We believe that the time is right for a wider range of public companies to consider these types of requirements.

A Session at the NASPP Annual Conference Devoted to HRTs. Because we expect many companies to be implementing HTRs for their CEOs and NEOs in time for this year's upcoming executive compensation proxy disclosures, we have arranged for Marc Trevino (see below) to head a panel at the upcoming NASPP Annual Conference devoted to HTRs. And, we have just received confirmation that Jim Parsons, who was instrumental in drafting and implementing ExxonMobil's approach, will join us on the panel. Marc and Jim will not only share with us their hands on guidance but will answer all your questions during (and following) the panel.

A Thank You

We would like to thank Marc Trevino of Sullivan & Cromwell and a member of the CompensationStandards.com Task Force for his significant contributions to the above piece. Marc's first hand experience with HTRs has given us invaluable insights into HTR design and implementation. We also owe a thank you to Marc and his colleague Joseph Hearn for the HTR documents that we have posted on CompensationStandards.com.

NEW DEVELOPMENTS

Proposed Regulations for Section 6039 Returns

In our November-December 2007 issue (at pg 10), we reported that, under the Tax and Health Care Relief Act of 2006, companies are now required to file Section 6039 returns with the IRS for ISO exercises and transfers of shares acquired under a Section 423 ESPP plan. Readers will recall that, up until passage of this legislation, companies have been required to provide informational statements to employees for these transactions but have not been required to file returns with the IRS (see our November-December 2005 issue at pg 11).

In late 2007, the IRS issued Notice 2008-8, temporarily suspending the requirement until regulations clarifying when and how to file the returns could be issued. [We understand that this notice was largely prompted by the NASPP's comment letter requesting clarification on the returns.]

On July 16, 2008, the IRS issued proposed regulations governing the returns. The good news

is that the proposed regulations would suspend the requirement to file the returns (and comply with the new regulations as they relate to the information statements provided to employees) for all of 2007 and 2008. The deadline for compliance for transactions that occur in 2009 will be January 31, 2010, giving companies ample time to prepare.

The proposed regulations don't really provide much information as to how to file the returns, other than to specify the information that must be included in them and indicate that, later this year, the IRS will publish forms that must be used to file the returns. We look forward to providing our readers with more information on filing the returns once the forms are available.

The IRS is soliciting comments on proposed regulations through October 15, 2008.

Proposed Regulations for ESPPs

When the IRS issued the final ISO regulations back in August 2004, it indicated that it was also working on final ESPP regulations; these proposed regulations were issued on July 29, 2008. While the proposed regulations are far more manageable in length than the final ISO regulations were (a mere 50 pages for the ESPP regs vs. 100 pages for the ISO regs) they still address more aspects of ESPPs than we can cover in full here, so we highlight only a few areas of the proposed regs that we find most significant.

\$25,000 Limitation

Perhaps the most significant area of the proposed regs, particularly for companies in Silicon Valley, is the "clarification" of the application of the \$25,000 limit to offerings that span a calendar year end. As our readers recall (see our January-February 1998 issue at pg 4), employees in a Section 423 qualified ESPP can purchase only \$25,000 worth of stock per year, based on the value of the stock on their grant/enrollment date. Where an offering spans a calendar year (e.g., a 24-month offering), any unused limit from the first year carries forward to the second year of the offering, increasing the amount employees can purchase in that year. Let's say that an employee enrolled in a 24-month offering purchases only \$20,000 worth of stock during the first year. The \$5,000 worth of stock still remaining available to the employee under the limit at the end of the first year is carried

forward to the next year of the offering, so that the employee could purchase \$30,000 worth of stock in that year.

Application to Purchase Periods That Span Year-End. Under §423(b)(8)(A), the right to purchase stock under the \$25,000 limitation accrues when the employee's right to purchase stock in the ESPP becomes exercisable. This language has generated some uncertainty as to how the limit (and carry forward) applies in an offering that spans a calendar year but where the employee doesn't have the ability to purchase any stock in the first year of the offering. Say an employee enrolls in a six-month offering that begins on October 1 and ends on March 31 of the following year, with the only purchase under the offering occurring on March 31. The employee won't purchase any stock in the first year of the offering, thus, theoretically, the employee will have a full \$25,000 worth of stock available under the limit at the end of that year. Does this \$25,000 carry forward to the second year of the offering, so that the employee can purchase \$50,000 worth of stock on March 31? Or, since the employee's right to purchase stock under the offering isn't exercisable until the second year of the offering, does this mean that the employee accrued no rights to purchase stock under the limit in the first year of the offering, thereby negating any carry-forward for that year, and limiting the amount of stock the employee can purchase on March 31 to \$25,000 worth?

Common practice, at least in Silicon Valley— we're not so sure about the rest of the country, has been to assume the former (more generous) approach (*i.e.*, that the employee in our example can purchase \$50,000 worth of stock on March 31) but the proposed regulations indicate the latter (more conservative) approach (*i.e.*, that the employee in our example is limited to purchasing only \$25,000 worth of stock on March 31) is correct. The regulations emphasize that employees have the right to purchase \$25,000 worth of stock only for those years in which their option under the ESPP (the offering period, for typical ESPPs) is both outstanding *and exercisable*. Moreover, an example of a six-month offering, similar to our example, has been added to regulations to further drive home the IRS's point.

Need to Change Practices Now? The IRS also indicates that this is a "clarification" of the existing requirements, not a change or a new

10 regulation, leading us to extrapolate that the IRS (or at least the authors of the proposed regulations) believes that the current ESPP regulations already require the conservative approach. So, while the proposed regulations have an effective date of January 1, 2010, companies that have been assuming that the current regulations allow the more aggressive approach may want to consider switching to the more conservative approach sooner rather than later.

Grant Date

As companies move towards ESPPs with a purchase price based on only the purchase date FMV (the 2007 NASPP Stock Plan Design and Administration Survey reported that 29% of respondents base the purchase price for their §423 ESPP on the purchase date FMV only, up from just 13% in the 2004 survey), the question of when the grant date occurs for tax purposes is muddier. The grant date is key to four purposes (i) establishing the minimum purchase price required under §423(b)(6); (ii) establishing the value of stock purchased under the plan for purposes of the \$25,000 limitation; (iii) establishing the start of the two-year statutory holding period for qualifying dispositions; and (iv) calculating compensation income on a qualifying disposition.

No Need for Fixed Price. The proposed regulations would codify positions previously expressed in IRS private letter rulings, namely that it is not necessary for the purchase price to be fixed (or to be based on the FMV) at the enrollment date for that date to be considered the grant date. The grant date would be the date upon which the corporate action necessary to constitute an offer of stock under the plan is completed, provided that the maximum number of shares employees can purchase under the plan is known or can be determined via a formula at that time. Thus, even for plans where the purchase price is based on the purchase date FMV only, the grant date could still be considered the enrollment date.

Share Limit is Required, However. Note, however, that for the enrollment date to be the grant date, the plan must specify the maximum number of shares employees can purchase, either in the form of a flat share limit or via a formula. The regulations expressly state that simply writing the \$25,000 limitation (as it is worded in the statute) into the plan is not sufficient for this purpose, nor is a limit on the maximum number

of shares that can be issued under the plan. Where the plan doesn't include an individual limit, the grant date will be the purchase date unless the minimum purchase price is fixed as of the enrollment date. This would essentially preclude the plan from having a lookback (*i.e.*, where the price is a percentage of the lower of the FMV at enrollment or purchase) because the grant would be the purchase date and under §423(b)(6), the purchase price could not be lower than 85% of the FMV on this date.

For plans where the price is already a percentage of the FMV on the purchase date only, not having an individually applied purchase limit would force employees to hold the stock for two years after purchase to engage in a qualifying disposition. But, where employees sell at a price higher than the FMV on the purchase date, this wouldn't matter. Because the grant date would be the purchase date, employees' compensation income on qualifying dispositions would be equal to the discount offered under the plan as applied to the grant/purchase date FMV. This will be the spread at purchase, which is the same amount of compensation income that employees would recognize on a disqualifying disposition. Thus, assuming the stock appreciates in value after the purchase, employees would have no incentive to meet the statutory holding periods. [The result is different if the stock price declines and employees sell at less than the FMV on the purchase date. In this scenario, employees' compensation income on a qualifying disposition would be limited to their actual gain on the sale, whereas on a disqualifying disposition it would still be the spread on the purchase date (see our March-April 2002 issue at pg 8).]

Treating the purchase date as the grant would also impact the number of shares employees can purchase under the \$25,000 limitation, but since we suspect that few employees ever exceed this limit, we imagine this consideration is secondary at best.

Exclusion of Certain Employees

§423(b)(4) requires that substantially all employees of the company must be allowed to participate in the plan, with exceptions only for employees that have not met a minimum service requirement, part-time employees, and highly compensated employees (as defined in §414(q)).

Highly Compensated Employees. The proposed regulations would expand the definition of highly compensated employees to also allow Section 16 insiders to be excluded either in addition to, or instead of employees that meet the definition under §414(q). The proposed regulations would also allow companies to exclude only a subset of employees that earn above a specified level of compensation, provided that the employees excluded are considered highly compensated under §414(q) and the exclusion is applied equally to all employees in all entities that are permitted to participate in the plan. Thus, the company would not have to exclude all highly compensated employees under §414(q) in order to exclude Section 16 insiders or those above a certain compensation level. For example, although, for 2008, §414(q) defines highly compensated employees as those earning above \$105,000, a company could choose to exclude only those highly compensated employees that earn above a higher threshold, say, \$300,000.

Non-U.S. Employees. The proposed regulations would allow companies to exclude non-U.S. employees if local law prohibits their participation in the plan or if they would have to be allowed to participate in a manner that would cause the plan to violate the requirements of §423. This is primarily a concern where non-U.S. employees are employed by the U.S. company, rather than by a foreign subsidiary. Companies can exclude employees in foreign subsidiaries simply by choosing not to designate the subsidiary as one of the corporate entities participating in the plan. While all employees of the sponsoring entity must be allowed to participate, it is not necessary to allow employees of the entity's subsidiaries to participate in the plan. Of course, if a subsidiary is allowed to participate, then all employees of the subsidiary must be permitted to participate on an equal basis with the employees in the sponsoring/parent entity.]

Likewise, the proposed regulations would allow companies to permit non-U.S. employees to participate in the plan on a less favorable basis than U.S. employees, if so required under local law. The reverse is not true, however; if local law requires additional benefits under the plan to be extended to non-U.S. employees, those benefits must also be extended to U.S. employees if the non-U.S. employees participate in the plan.

Comment Directly to the IRS at the NASPP Conference in October

The IRS is soliciting comments on the proposed regulations through October 27, 2008. We look forward to hearing more about these regs and the §6039 regs, as well as the latest updates on Section 409A and Section 162(m) during the popular session *The IRS and Treasury Speak: The Hottest Tax Issues for Stock Compensation* at the NASPP Annual Conference in October. A long-standing tradition at the Conference, this session, which includes representatives from both the IRS and Treasury as well as former Treasury staffers, has become a valuable opportunity for an exchange of ideas between practitioners, issuers, and regulators. Although not a substitute for submitting a comment letter, this session does afford attendees the opportunity to make suggestions to the IRS and Treasury; if you have an opinion on any of the recently proposed or issued regulations relating to stock compensation, you won't want to miss your chance to voice it during this session.

KEEPING UP

A Roadmap to Comply with the SEC's New Regulation FD Guidance

Now that the SEC has made dramatic changes to its positions on what companies can—and should—do online, opportunities (and pitfalls) abound. We have just reviewed the upcoming Fall issue of the *InvestorRelationships.com* newsletter, which provides important practical guidance that our readers who counsel public companies will need. The newsletter is an integral part of the important new website—*InvestorRelationships.com*—that Broc Romanek has created to help all those responsible for investor relations and corporate governance keep abreast of the fast-paced changes impacting this area. Be sure that you and clients are taking advantage of this invaluable, new resource.

“The SEC's New Corporate Website Guidance: Everything You Need to Know—And Do Now”

We owe Broc a debt of gratitude for having assembled the foremost experts—including key SEC Staff—who will address head-on many of the most important questions that practitioners are

now asking during the upcoming WebConference, “The SEC’s New Corporate Website Guidance: Everything You Need to Know—And Do Now” providing us all with the answers and practical guidance that so many of us will need in the days ahead. To receive the upcoming issue of *InvestorRelationships.com* and to access this critical upcoming WebConference, we encourage all our readers to go to *InvestorRelationships.com* and take advantage of the no-risk membership offer.

Wealth Accumulation and “Walk Away” Amounts

Those of our readers involved in executive compensation and/or proxy disclosures will want to make sure to see next week’s issue of *Compensation Standards*, the newsletter that has become an important part of *CompensationStandards.com* memberships. This issue (which will be mailed to every director) focuses on the importance, for your CD&A disclosures (and in fulfilling directors fiduciary responsibilities), of assembling wealth accumulation/full “walk away” numbers. Readers will want to have that issue in hand to be prepared for calls from the CEO and directors.

New Advisors’ Blog

We would like to call our readers’ attention to the new *The Advisors’ Blog*, maintained by several of the leading compensation consultants and practitioners. We are finding it to be a great way to keep abreast of the latest guidance and practices. Coupled with Mark Borges’ Proxy Disclosure Blog and Mike Melbinger’s Compensation Blog, these blogs alone are reason to make sure that all your key people are taking advantage of the invaluable resources which are part of your *CompensationStandards.com* membership.

Upcoming Conference Week

The most important conferences of the year for those of us involved in executive compensation

as well as proxy disclosures are upon us. Those readers who cannot take in the October 22nd “3rd Annual Proxy Disclosure Conference” and the October 23rd “5th Annual Executive Compensation Conference” are encouraged to take advantage of the enclosed form which will enable you to view the Nationwide Video Webcasts—and to have ongoing access to the video archives and materials. Those who can make it to New Orleans, where these critical Conferences will be held, will be joining a large number of our colleagues (we are expecting over 2,000) who will be taking in this year’s NASPP Annual Conference and the 40-plus sessions, including the HTR, IRS and net exercise sessions we have referred to in this issue. See You There!

It’s Renewal Time

As all subscriptions to *The Corporate Executive* are on a calendar year basis, renewal time is upon us. Please return the enclosed Renewal Form or (to save time and trees) please go to the “Renewal Center” on *TheCorporateCounsel.net* to renew your subscription (note the reduced price when you renew your subscription to *The Corporate Counsel* at the same time).

We thank our readers for the many kind comments we have received from you during this past year. With the continuing rise in importance of executive compensation and proxy disclosure, our readership (both within companies and law firms) has been growing significantly. We thank you for your word of mouth referrals. This coming year promises to bring more changes. We will continue to give you our best to keep you abreast of the latest practices and guidance.

Trial Subscriptions

We encourage those who may not yet subscribe to *The Corporate Executive* to take advantage of the enclosed 2009 No-Risk Trial.

—JMB

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