

3rd Annual CEP Symposium 

## Certified Equity Professional Institute

Thinking Differently About ESPPs

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### Participation Rates Are Irrational

- 2006 NCEO study found that in one-third of the companies fewer than 20% of the employees participate, and in another 24%, 20% to 40% participate. Only 18% of the companies have greater than 60% participation.
- Participation rates dropped by about 40% from 2000 to 2004.

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### Why Participation Rates Are So Low

- Little effort to educate employees
- Aversion to and unfamiliarity with stock
- Some plans are becoming less attractive
- Strong preference/need for current income: most people prefer \$5 today to \$10 next week (literally).

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**So What Can You Do?**

- Educate people more—but you’ve heard that before and (let’s be honest) the message isn’t having much impact.
- Provide longer look-back, bigger discounts (but that’s not the direction we’re headed).
- Think good thoughts and hope they will turn into ESPP fairy dust (the most common approach).

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**The 401(k) Op-Out Model**

- “Opt-out” is the hot new idea in 401(k) participation. Low 401(k) rates are caused by much the same issues as low ESPP rates. Opt-out programs appear to increase enrollment by a third to a half or more.
- Some companies had opt-out programs prior to 2006, but many worried about state laws that potentially prohibit such programs by requiring employee consent to take money from their paychecks.
- Opt-out programs were given clear statutory blessing in the 2006 reform of pension law, but only for 401(k) and similar plans.

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**Problems for ESPP Opt-Out Models**

- Federal and state do not appear to allow such programs on the grounds that employers need consent for payroll deductions not meeting specific requirements, although there appear to be no test cases to see if an opt-out option for ESPPs can be construed as consent.
- Some states, such as California, prohibit required purchases of employer securities.
- Employees might be less convinced that an opt-out program is in their benefit in an ESPP.

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### The Profit Sharing ESPP Opt-Out

- One possible solution would be to have a cash profit sharing plan with an ESPP option.
- When the profit sharing is paid, employee will be given two choices: do nothing and have the money put into the ESPP or return a form and get cash. Taxes would be taken out beforehand in either case.
- Would this pass the legal tests? It seems like it provides at least implied consent, but legal counsel needs consulting.
- It could also be structured just as "choose one."

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### Why Even an Opt-In Tied to Profit Sharing Might Work

- If the company required an affirmative choice, but the employee doesn't have to do anything but say yes and maybe choose from among a couple of different percentages (not firms to fill out and return other than one that has to be filled out anyway), it's easier to participate.
- The payment gives the company a great opportunity to illustrate the advantages of opting in by presenting some possible scenarios at a time employees will actually be paying attention.
- Could provide a somewhat larger profit sharing percentage if employees opt in, or maybe some kind of fun prizes.
- If lots of people sign up, but withdraw, it would affect accounting costs.

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### The Dexia Model

- Concept now in use by Dexia Bank in Europe, including U.S. employees.
- A lender loans money to employees to purchase shares upfront at a 20% discount. Employees buy one share and gets nine more with a loan.
- Employees repay the loan after five years in shares, not cash. The number of shares needed to repay the loan is set at the loan date.

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### The Dexia Model (cont.)

- If, at the end of five years, the share price is insufficient to pay the loan, the employees get whatever they have invested back (without interest).
- If it is sufficient, enough shares are sold to pay the loan, and the added value goes to the employee.
- Outside lender makes the loan and hedges in the securities market to cover risk of share price decline.
- In the U.S., shares would have to be in the form of an option to avoid margin loan issues. Employees would not actually own the shares until the end of the term.
- 80% participation rate achieved in Europe.

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### The Leveraged ESPP

- A variant on this approach engages a third-party lender to loan money to employees to participate in an ESPP using a line of credit.
- At the end of the offering period, the employee repays the lender a number of shares guaranteed at the outset of the loan.
- Lender hedges in the securities market to protect against risk.

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### Leveraged ESPP Issues

- May appear to be "net exercise" that regulators do not think fits within ESPP rules, so a non-qualified plan may work better (but, in reality, this is not much of an issue for employees who rarely meet holding periods for a qualified plan).
- Margin loan rules could make it necessary for employees to surrender stock at exercise. It's not clear if all the shares would need to be surrendered, however, or just those used to repay the loan.
- Clearly needs testing beforehand with legal counsel and maybe a private letter ruling.
- Might incur accounting costs for no benefits if lots of employees withdraw.

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### The Lottery Plan

- People are just as irrational about playing the lottery as they are about *not* investing in ESPPs.
- So set up a lottery!
- For every percentage of pay put aside, give the employee x number of lottery tickets for a drawing every offering period. Lottery behavior indicates a small number of very large prizes works better than a large number of small ones.

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### Thinking Outside the Envelope

A *Wall Street Journal* cartoon showed two homeless executives walking down the street, one saying to the other:

"My problem was I pushed the box and thought outside the envelope."

Good luck getting it right.

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