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What You Need to Know About ISS's Policies for 2019

Getting Ready for Your Next CEO Pay Ratio Disclosure

Solving the Challenges of Global ESPPs

A Word from the Editor

We lead off this issue with articles on key considerations for the 2019 proxy season. Our first article provides an update on changes to ISS's compensation policies for the 2019 proxy season.

On pg 1, we look at ISS's policies on executive compensation, including problematic pay practices companies need to be wary of. And on pg 3, we dive into ISS's policies for equity compensation, including changes to the Equity Plan Scorecard for this year's proxy season. We note that ISS is already updating their policies to encourage companies to continue practices that were established in response to Section 162(m) and which will soon no longer be necessary for that purpose.

Our second article in this issue, on pg 4, highlights practitioner and investor comments on the CEO pay ratio disclosure from last September's Pay Ratio & Proxy Disclosure Conference and offers guidance for the second year of this disclosure. The good news is that most companies won't need to identify a new median employee. The bad news is that some investors want to see even more disclosure.

We recently learned about a very unique and innovative employee stock purchase plan adopted by SAP. We were excited to learn more about it and to bring the plan to the attention of our readers. One of the key features of the plan is a 40% match on employee contributions, a feature rarely seen in ESPPs (at least in the United States). On pg 6, we take an in-depth look at the plan.

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Changes to ISS Policies for 2019

As always, ISS issued its updated policies on executive and equity compensation for 2019 in December. ISS issued two sets of updated FAQs: one for U.S. equity plans and one for U.S. compensation policies.

Compensation Policies

New or changed information in the Compensation Policies FAQs includes the following:

Use of TSR. ISS has long used TSR in its quantitative screen, and companies had begun to ask whether ISS prefers that they use TSR as an incentive program metric. In response, ISS indicates in the FAQs that "ISS does not endorse or prefer the use of TSR or any specific metric in executive incentive programs" as it "believes that the board and compensation committee are generally best qualified to determine the incentive plan metrics that will encourage executive decision-making that promotes long-term shareholder value creation."

Problematic Practices. ISS again lists the problematic practices that are "most likely" to result in adverse vote recommendations for Say-on-Pay proposals. With the exception of problematic definitions of "good reason" (discussed below), ISS has identified all the practices listed as problematic in prior years. The list includes the following practices:

- Repricing or replacing of underwater stock options/SARS without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options);
- Extraordinary perquisites or tax gross-ups;
- New or materially amended agreements that provide for (i) excessive termination or CIC severance payments (generally exceeding three

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times base salary and average/target/most recent bonus) or (ii) CIC severance payments without involuntary job loss or substantial diminution of duties ("single" or "modified single" triggers) or in connection with a problematic "good reason" definition;

• CIC excise tax gross-up entitlements (including "modified" gross-ups);

• Multiyear guaranteed awards that are not subject to rigorous performance conditions;

• Liberal CIC definition combined with any single-trigger CIC benefits; and

• The vague "Any other provision or practice deemed to be egregious and present a significant risk to investors."

<u>"Good Reason" Termination Definitions.</u> ISS adds to its list of problematic practices "good reason" termination definitions that present windfall risks, such as definitions triggered by potential performance failures. The FAQs state that companies should limit change-in-control severance payable in connection with a "good reason" termination to circumstances that are reasonably viewed as an adverse constructive termination, such as employer actions that result in a material negative change to the executive's title/role, function, or compensation. ISS considers definitions problematic if they are triggered by circumstances reflecting potential performance failures, such as a company bankruptcy or delisting.

<u>"Front-Loaded" Equity Awards.</u> ISS states that it is unlikely to support equity grants that cover more than four years (*i.e.*, the grant year plus three future years) because such awards limit the board's ability to meaningfully adjust future pay opportunities in the event of unforeseen events or changes in either performance or strategic focus. ISS will more closely scrutinize pay-for-performance considerations, including completeness of disclosure, emphasis on transparent and rigorous performance criteria, and stringent vesting provisions that limit windfall risk. In situations where the company commits to not granting additional awards over the covered period, the company should make that commitment explicit and firm.

Glass Lewis also updated its voting policy this year to discourage front-loaded equity awards. We are skeptical that it is a coincidence that both advisory firms made this change this year. We wonder if it is perhaps a reaction to Elon Musk's mega grant, which was intended to serve as compensation for ten years (see our May-June 2018 issue at pg 9).

<u>Companies Now Reporting Under Smaller Reporting Company Rules.</u> As we discussed in our November-December 2018 (at pg 8) the SEC has increased the reporting threshold so that many more companies will qualify for the less stringent proxy statement reporting rules applicable to smaller reporting companies. However, despite the SEC's scaled-back compensation disclosure requirements, the FAQs warn that ISS will continue to expect sufficient disclosure to enable investors to make an informed Say-on-Pay vote. Specifically, ISS states that it is "unlikely to support a Say-on-Pay proposal if compensation disclosure is such that shareholders cannot meaningfully assess the board's compensation philosophy and practices." (Previously, Glass Lewis declared that it will review year-on-year CD&A texts of an SRC to determine whether disclosure substantially decreased. In such cases, a vote recommendation against the entire compensation committee may result.)

<u>Use of EVA.</u> Readers may recall that two years ago, ISS announced that it would be featuring economic value-added measures in its research reports. The FAQs confirm that ISS will continue to use GAAP/accounting performance measures in its financial performance assessment screen. ISS indicates that it will display EVA measures in its research reports on a "phased-in basis over the 2019 proxy season," although not as part of the quantitative pay-for-performance screen, and will continue to explore the potential for future use of EVA measures.

<u>Excessive Nonemployee Director Pay.</u> ISS had also announced a policy to potentially issue adverse vote recommendations for board members responsible for approving/setting a recurring pattern of "excessive" nonemployee director pay without a compelling rationale. Following additional investor feedback, ISS updated the methodology to identify director pay outliers, and, in consideration of the methodology change, ISS announced that it will not issue adverse recommendations under this policy until meetings occurring during the 2020 proxy season (*i.e.*, for companies in which ISS has identified excessive director pay without compelling rationale in both 2019 and 2020).

<u>Disclosure by Externally Managed Issuers.</u> ISS also adds insufficient executive compensation disclosure by externally managed issuers (typically REITs), to its list of problematic practices.

Equity Compensation Plan FAQs

New or changed information in ISS's FAQ on U.S. equity compensation plans includes the following:

Changes to EPSC policy for 2019. ISS announced a few changes to the Equity Plan Scorecard, effective for meetings as of February 1, 2019.

First, the change-in-control vesting factor will be updated to provide points based on the quality of disclosure of CIC vesting provisions, rather than based on the actual vesting treatment of awards. Specifically, ISS will award full points for this factor where the company's equity plan discloses with specificity the CIC vesting treatment for both performance- and time-based awards. If the plan is silent on the CIC vesting treatment for either type of award or the plan provides for merely discretionary vesting for either type of award, ISS will award no points for this factor.

In our November–December 2018 issue (at pg 2), we noted our suspicion that ISS is relaxing this factor, with a plan to tighten it back up in the future once companies have developed better disclosures. We also note that better disclosures of CIC provisions in equity awards will help ISS with its assessment of problematic pay practices (discussed above).

Second, in light of the elimination of the exemption for performance-based awards under Section 162(m), which required frequent shareholder reapproval of equity plans, ISS has increased the weighting of the plan duration factor to encourage plan resubmission to shareholders more often than is required by the stock exchanges.

The passing scores for all U.S. EPSC models will remain the same as those in effect for the 2018 proxy season (*i.e.*, 55 points for S&P 500 companies and 53 points for Russell 3000 companies (not including S&P 500)).

Overriding Factors. ISS announced a new negative overriding factor relating to excessive dilution for the S&P 500 and Russell 3000 EPSC models. The new overriding factor will be triggered when a company's equity compensation program is estimated to dilute shareholders' holdings by more than 20% (for the S&P 500 model) or 25% (for the Russell 3000 model).

With this new factor, the following "egregious" features may result in an "against" recommendation, regardless of other EPSC factors:

- A liberal change-of-control definition that could result in vesting of awards by any trigger other than a full double trigger (better disclosure of CIC provisions, as discussed above, also helps ISS assess whether this overriding factor should be applied to a plan);
- If the plan would permit repricing or cash buyout of underwater options or SARs without shareholder approval;
- If the plan is a vehicle for problematic pay practices or a pay-for-performance misalignment;
- If the plan is estimated to be excessively dilutive to shareholders' holdings; or
- Other plan features or company practices that could be detrimental to shareholder interests, including (but not limited to) tax gross-ups related to plan awards, provision for reload options, or provision for transferability of stock options to third-party financial institutions without shareholder approval.

Amendments to Increase the Applicable Tax Withholding Rate. ISS generally takes a benign view of plan amendments to increase the tax withholding rate, unless the plan contains a liberal share recycling feature. This concern would be mitigated if the plan stipulates that only the number of shares withheld at the minimum statutory rate may be recycled.

Proposals Seeking Approval Only to Qualify Grants as "Performance-Based" Under Section 162(m). To the extent any grandfathered performance awards remain outstanding under a company's stock plan, the company will still be required to submit the plans under which the awards are granted to shareholder approval at least once every five years. Shareholder proposals that seek approval only to ensure tax deductibility of awards pursuant to the grandfather rule under Section 162(m) and that do not seek additional shares for grants or approval of any plan amendments will generally receive a favorable recommendation, regardless of EPSC factors, provided that the board's compensation committee or other administrating committee is 100% independent according to ISS standards.

Because most performance awards have a performance period of three years (according to the NASPP/Deloitte Consulting Stock Plan Design Survey), most companies needing to seek shareholder approval of a plan solely for Section 162(m) purposes will only need to worry about this one more time, if that. Unfortunately, because of the additional weight ISS has assigned to the plan duration factor of the EPSC, companies may be forced to allocate fewer shares more frequently to their plans; new share allocations receive more rigorous review from ISS than did requests for shareholder approval of a plan solely for purposes of Section 162(m) compliance.

Rather than requesting fewer shares for the plan, companies could presumably earn points for the plan duration factor by stipulating a plan expiration date that is less than five years (full points) or six years (half points), but we don't expect this to emerge as a trend. An amendment to extend the expiration date generally receives the same scrutiny as a new share allocation.

Other Changes for Section 162(m). ISS will view plan changes that remove general references to Section 162(m) qualification (*e.g.*, references to approved metrics) as neutral. However, ISS will view negatively the removal of provisions that are considered good governance practices, such as individual award limits. And we remind readers that, as long as individual award limits remain in plans, these limits must be complied with, even though they are no longer necessary for Section 162(m) purposes.

The presence of such limits is not currently a factor in the EPSC, so we presume that ISS is not requiring them for newly adopted plans. However, ISS has indicated its belief that limits are still a best practice.

Nonemployee Director Equity Plans. ISS will not evaluate stand-alone director equity plans under the EPSC model but, generally, will recommend against a plan that contains egregious features, such as non-shareholder-approved option repricing. However, in cases where the plan exceeds the SVT or burn-rate benchmark when combined with employee equity compensation plans, ISS will supplement its analysis with a qualitative review of board compensation, which includes the following factors:

- The relative magnitude of director compensation as compared to those of companies of a similar profile;
- The presence of problematic pay practices relating to director compensation;
- Director stock ownership guidelines and holding requirements;
- Equity award vesting schedules;
- The mix of cash and equity-based compensation;
- Meaningful limits on director compensation;
- The availability of retirement benefits or perquisites; and
- The quality of disclosure surrounding director compensation.

Year 2 of the CEO Pay Ratio Disclosure: Some Investors Want More Details

A year and a half ago, some speakers at CompensationStandards.com's 2017 Pay Ratio & Proxy Disclosure Conference predicted that the CEO pay ratio disclosure requirement would be repealed before the then-upcoming 2018 proxy season. As we know, that did not happen. In 2018, disclosure of CEO pay ratios turned out to be a nonevent for the vast majority of companies. The media reported some disclosures, particularly the higher ones, but the story never got legs. However, rather than fading away (or being repealed), the CEO pay ratio disclosure seems to be generating more interest this year than last.

Lessons Learned from 2018 Disclosures

After reviewing the first round of CEO pay ratio disclosures and listening to feedback from investors, certain lessons have become apparent, which may be helpful for year 2 disclosures. The investors and compensation professionals on the panels at the September 2018 Pay Ratio & Proxy Disclosure Conference agreed that the best approach to CEO pay ratio disclosure is to keep it simple. Investors observed that they found lengthy explanations of the CEO pay ratio and alternative versions of the ratio confusing. Some investors speaking at the Conference flatly stated that a company's use of an alternative calculation of the ratio and/or a lengthy and complicated disclosure raised their suspicion that the company was trying to hide something. Therefore, companies and their counsel should resist the urge to explain or provide supplemental disclosure.

Disclosure Should Be Easier for Most Companies in 2019

Determining the median employee and the rest of the calculation process should be easier this year. Many companies should be able to use the same median employee in 2019 as they used in 2018. Instruction 2 of Reg S-K Item 402(u) requires a company to identify its median employee only once every three years unless there has been a change in (i) the original median employee's circumstances or (ii) the company's employee population or compensation arrangements that the company "reasonably believes would result in a significant change in its pay ratio disclosure." For example, if the median employee used in calculating the CEO pay ratio for year 1 received an unusually large bonus or equity award in year two, the company probably could not use that employee. Similarly, if the company substantially increased in size because of a significant acquisition in year two (or shrunk due a significant divestiture), the company should not use the same individual as the median employee. (We remind readers that the median employee's pay for purposes of calculating the ratio must be newly determined each year, even if the specific employee identified as the median doesn't change.)

For most companies, determining the median employee is by far the costliest and most time-consuming aspect of disclosing the CEO pay ratio. The company must calculate the CEO's total compensation for purposes of the Summary Compensation Table regardless of the pay ratio disclosure; this portion of the disclosure doesn't add to the company's cost or efforts. Once the median employee is selected, the company only need apply to him or her the same calculation methods it used for the CEO (with some exceptions permitted by SEC rules).

In an entry dated February 15, 2019, in his Proxy Disclosure blog on CompensationStandards.com, our friend Mark Borges pointed out a recent disclosure by USG Corporation that uses the same median employee in year two as in year one.

Renewed Interest and Shareholder Activism for the CEO Pay Ratio Disclosure

Into this happily settled situation came a bombshell. In December 2018, a group of 48 public employee union pension funds, religious orders, and social investment funds sent a letter to the board of directors of every public company included in the S&P 500 index seeking expanded CEO pay ratio disclosures in proxy statements. The group, purportedly representing $3.3 trillion in assets under management and advisement, favors "pay ratios that indicate that companies are making investments in their employees and that CEO compensation is set within the parameters of the company's overall compensation philosophy." The group believes that supplemental disclosure will help investors put the pay ratio information in the context of the company's overall approach to human capital management. The group also mentioned in its letter that pay ratio disclosure is useful for Say-on-Pay voting decisions.

The group suggested supplemental disclosure (which Item 402(u) permits) as to the CEO pay ratio and lists 12 specific additional disclosures that they believe to be best practice, which include the following items:

- Identification of the median employee's job function
- Breakdown of the workforce by job function and/or business unit
- Geographic location of the median employee
- Country-level breakdown of global employee headcount
- A breakdown of full-time vs. part-time employment status
- Use of temporary or seasonal employees
- Use (or non-use) of subcontracted workers
- Tenure and experience of the workforce
- Workforce education levels and skill sets
- The company's overall compensation philosophy
- Employee compensation mix (benefits and incentives)
- Alignment of CEO pay practices with pay practices for other employees

And the group did not stop there. Apparently led by the ambitious politician Thomas DiNapoli, acting in his capacity as New York state comptroller, the group filed stockholder resolutions against several of the companies. Also in December, DiNapoli, one of the signatories to the letters, issued a press release, no doubt for the benefit of the retirement fund beneficiaries, announcing that his retirement fund had reached agreements with Microsoft, CVS Health, Macy's, The TJX Companies, and Salesforce "to reexamine their CEO and executive pay and adopt policies that take into account the compensation of the rest of their workforces." In response to the agreements, the fund withdrew its shareholder resolutions with the companies.

Other recent shareholder resolutions on this topic have included requests that the company prepare a report on its policies and goals to identify and reduce inequities in compensation due to gender, race, or ethnicity within its workforce, defined as the difference, expressed as a percentage, between the earnings of each demographic group in comparable roles. Some have suggested that companies should consider using the data collection and calculation process developed in connection with the CEO pay ratio disclosure to review gender pay equity (which may be required by law or best practice at some future date). However, in light of litigation and state and local laws developing on the issue, this is one task you do not want to undertake without the protection of the attorney-client privilege.

What to Do Now

So, what is a company to do: include a simple disclosure, as many investors want, or a more detailed disclosure, which some other investors want? Understanding that you can't please all of the people all of the time, companies might consider whether any of the 48 signatories to the aforementioned letter hold a significant ownership position in their stock. If the fund's ownership percentage is significant, companies ought to consider the request.

The history of these activist groups pushing for more and better compensation clawback policies demonstrates that they don't just go away. DiNapoli and his ilk are likely to continue submitting shareholder proposals, pushing for settlements, and issuing press releases for the foreseeable future. For shareholder proposals in other areas, they have filed lawsuits against companies seeking declaratory and injunctive relief with the stated goal of ensuring that the shareholder proposals are included in the proxy solicitation materials, and urging the SEC to leave the matter to the courts. It is not clear how this fulfills their fiduciary duties to act solely in the interests of participants and beneficiaries of their funds, but there it is.

SAP's Outside-the-Box ESPP

As our readers know, we are fans of employee stock purchase plans, especially in volatile markets (see our November–December 1998 issue at pg 1). We are also very interested in outside-the-box ideas for ESPPs (see our January–February 2007 issue at pg 1). We recently came across one such ESPP: SAP's worldwide ESPP bears little resemblance to a traditional U.S.-style ESPP but manages to deliver a great benefit to employees while mitigating shareholder dilution and easing multinational tax compliance. We think it is worth a closer look.

How SAP's Plan Works

SAP is a German-headquartered company with nearly 100,000 employees in approximately 150 countries. Although a significant population of SAP employees are located in the United States, SAP also has a significant population of non-U.S. employees. As explained to us by Sandra Sussman, Director of Global Equity Design and Strategy for SAP, in implementing an ESPP, SAP's goal was not only to make employee ownership accessible to all employees but to also, as much as possible, make the plan available on the same basis to all employees, regardless of local economic conditions or regulatory regimes. SAP's hope is for the plan to serve as a wealth-building vehicle for all employees while also enabling employees to participate in SAP's success.

The ESPP that SAP implemented, referred to as "Own SAP," allows employees to set aside contributions from 1% to 10% of their base compensation for the purchase of SAP stock. And that's about where the resemblance to a U.S.-style Section 423 qualified ESPP ends.

The plan is an open market plan, so employees pay full fair market value for the stock, and SAP matches up to 40% of each employee's contributions. In addition to the match, all employees below the executive level receive a €20 subsidy (about $23). Purchases occur on a monthly basis. SAP's contributions (both the match and the subsidy) are capped at €6,000 (currently about $6,800) per employee per year. Once employees purchase the stock, they own it freely, with no holding requirements or vesting conditions.

Finally, the plan is a nonqualified plan, which means that, unlike in a typical Section 423 ESPP, taxation for U.S. purposes is not deferred until the shares are sold (which is how ESPPs are typically taxed outside of the United States). Because the purchase price of shares acquired under the Own SAP plan is the full FMV of the stock at the time of purchase, the taxable income employees recognize is limited to SAP's matching contributions and the €20 subsidy.

Potato, Potahto, Match, Discount

One of the unique features of Own SAP is that the plan provides a match instead of a discount.

Economically, a match delivers the same benefit as a discount: a 40% match provides the same return to employees as a 29% discount. There are, however, a number of noneconomic ways in which a match differs from a discount.

Open Market ESPPs and Discounts Don't Mix. With an open market ESPP, such as Own SAP, a discounted price isn't possible. When treasury or authorized but unissued shares are transferred to employees, the company can set the price at whatever amount it wants. (Even if the stock is subject to par value, when issuing stock to current employees, the company can generally treat past service as consideration and, thus, can set the price below par value.)

But when employees are buying stock from the open market, they have to pay full price for the stock, even if the company is facilitating the purchase. Thus, for companies that want to offer an open-market ESPP, a match is the only tool available to provide a compensatory benefit under the plan.

Matches May Be Easier to Explain to Employees. We wonder if the idea of a match might be more appealing to employees than the idea of a discount. We often hear the phrase "free money" bandied about in reference to company matching contributions offered through 401(k) plans, but, to our knowledge, this term is never applied to the discounts offered under traditional ESPP plans. We suspect that it is easier to communicate the value in receiving X matching dollars for every one dollar contributed than the value in buying stock at a discount, especially for employees who have little or no experience investing in the stock market (or, for some non-U.S. employees, with capitalism).

We've also heard from readers who find that employees sometimes use the ESPP as an inefficient savings vehicle, contributing throughout the offering but withdrawing all their contributions just before the purchase, without realizing any return. Where an ESPP offers a match instead of a discount, this behavior would result in forfeiture of the match. While employees might be willing to forgo the right to buy stock at a discount, we expect that many employees would be more reluctant to forfeit matching contributions and, thus, might be less inclined to withdraw just before the purchase.

Pros and Cons of Open Market ESPPs

Most companies that offer ESPPs in the United States do not offer open-market plans; this is another feature of Own SAP that distinguishes it from the crowd. There are a number of advantages to open-market ESPPs but also some disadvantages (one of which, that the plan can't offer a discount, we've already discussed).

No Dilution. One advantage to an open-market ESPP is that the shares employees are purchasing are already issued and outstanding, so the plan is not dilutive. (To clarify, an open market plan doesn't result in any additional dilution in that it doesn't result in the issuance of new shares; assuming employees hold the stock acquired under the plan, voting power is still transferred from outside investors to employees. For most companies, however, the votes held by employees are likely insufficient to swing a shareholder election, nor can companies assume that employees will vote with management.) The plan would not have any effect on the company's basic or diluted earnings per share calculations (because the shares are already issued and outstanding and thus are already included in EPS), and the company would not need to implement a repurchase program to offset the shares issued under the plan.

Impact on Stock Price. Some companies that offer ESPPs find that their stock price declines slightly after a purchase because their stock's daily trading volume is not sufficient to absorb all the employee sales. It's possible that an open-market ESPP would have the opposite effect. The large acquisition of stock needed to fill employee purchase requests might give the stock a bump in price (of course, if a majority of employees immediately sell the stock, the bump would be short lived).

This is a potential challenge to implementing an open-market ESPP, particularly a plan like Own SAP, which is likely to be popular with employees: the company's stock must have sufficient trading volume to support the purchases. Moreover, companies would not want to give investors or regulators the impression that the plan is a vehicle for manipulating the company's stock price.

The monthly purchase frequency under SAP's plan helps to mitigate this concern by reducing the number of shares purchased on any given purchase date. It would be more challenging to implement a plan with purchase frequencies similar to those that we see in plans that do not involve open-market purchases (under which shares are typically purchased only two or four times per year).

Shareholder Approval Considerations. Both the NYSE and Nasdaq exempt open-market purchase plans from the requirement that listed companies obtain shareholder approval for equity compensation plans that they offer, but it does not appear that this exemption can be relied on for plans that match employee contributions.

Questions A-1 and A-4 in the NYSE's FAQs on its requirements in this area state that shareholder approval is required for plans in which the company matches a percentage of employee contributions. Both questions are silent as to whether this applies to all plans or just plans in which the company is issuing stock to employees, but question A-5 states that where employees do not have a choice of receiving compensation delivered under a plan in cash, the plan is subject to shareholder approval, regardless of whether the shares issued under the plan are new or treasury shares or purchased from the open market. Question A-5 addresses shares purchased by a trust on behalf of employees, but it seems that the NYSE's response would be applicable in other circumstances, as well. We did not find any discussion of this question in the Nasdaq's FAQs, but we expect that Nasdaq's position would align with the NYSE's.

No Cash Flow. An obvious disadvantage of open-market purchase plans is that these plans do not result in positive cash flow for the company; instead, the company match results in negative cash flow. While ESPPs generally aren't implemented for purposes of raising capital (plans that are implemented primarily for capital-raising purposes cannot be registered on Form S-8), some companies find the cash flow generated by the plan to be a nice benefit.

Why a Nonqualified Plan?

Although nonqualified plans are relatively unusual here in the United States (only 13% of respondents to the NASPP/Deloitte 2017 Domestic Stock Plan Administration Survey offer a nonqualified ESPP, whereas 43% offer a Section 423 qualified ESPP), it is rare for the preferential tax treatment to extend to non-U.S. employees. Thus, though the nonqualified status of the plan is a disadvantage for U.S. employees, it is a neutral factor for most non-U.S. employees. For companies like SAP, which have considerable employee populations outside of the United States, tax qualification of an ESPP within the United States results in an inherently unequal benefit program.

And, as we have discussed before, nonqualified plans offer significantly more flexibility than qualified plans (see our January–February 2007 issue at pg 3). Many of the key features of Own SAP would not be possible in a qualified Section 423 plan.

Match Not Permitted Under Section 423. It's questionable whether a match is permissible under Section 423. Even though a 17.6% match on employee contributions delivers the same economic benefit as the maximum 15% discount permitted under Section 423 (see our November–December 1998 issue at pg 2), Section 423 simply doesn't contemplate this benefit being delivered in the form of a contribution match. Given that Section 423 is silent on the topic of contribution matches, it might theoretically be possible to make an argument, by analogy to a discount, that a match is permissible. However, this would be an aggressive position and, in light of the high level of risk here (if it turns out that the match is not permissible, the entire plan would be disqualified, which would result in penalties that apply not only to the company but also to employees participating in the plan, who will have underreported their income in the years that they purchased stock under the plan), we do not recommend offering a match in a qualified ESPP without obtaining a letter ruling from the IRS blessing this approach.

The match is a critical component of Own SAP. As we note above, because the plan is an open-market plan, matching employee contributions is the only way SAP could deliver a compelling benefit to employees and mitigate their risk of investing in company stock. Plans in which employees pay full price for the stock without offering a match or a discount typically have very low participation rates. Employees tend to be risk averse and unwilling to invest in company stock (especially when their livelihood and possibly a significant percentage of their wealth is tied to their employer) without some sort of benefit that helps mitigate their investment risk. In addition to providing a benefit to employees, the match also serves a second purpose for SAP by facilitating the required tax withholding (more on this below).

Discount in Qualified Plan Can't Exceed 15%. Another advantage of a nonqualified ESPP is that the discount is not limited to 15%. The 40% match offered under Own SAP provides a very generous benefit to SAP employees, as we previously noted, equivalent to a discount of 29%.

Subsidy for Nonexecutives Not Permissible Under Section 423. The flat €20 subsidy that SAP provides to all nonexecutive participants addresses a concern that many multinational companies face when offering an ESPP to their non-U.S. employees: as a result of differences in local economies, some employees simply don't earn enough to participate in the ESPP in a meaningful way. Here, in the United States, €20 might not seem like much, but Sandra notes that, for some employees, the subsidy can double their monthly contributions. At SAP's current stock price of just over $100, it allows employees to purchase just over 2.5 shares per year. For employees whose contributions are sufficient to purchase only a few shares or less per year (a situation that can arise in global ESPPs), that is likely the difference between participating and not participating.

A subsidy that is available to only some plan participants is clearly not permissible under Section 423, even if the participants who don't receive the subsidy are executives (who clearly don't need it). It is permissible to exclude Section 16 insiders and highly compensated employees from a qualified ESPP, but, if they are allowed to participate, they have to be allowed to participate on the same basis as everyone else.

Nonqualified Plans Offer Greater Flexibility. Because nonqualified plans don't have to comply with the requirements of Section 423, the plans offer significantly more flexibility to the granting corporation. There are no limits on which types of service providers can be permitted to participate in the plan: contractors, consultants, and even nonemployee directors could be permitted to participate. Likewise, the individuals can be excluded based on any criteria that do not run afoul of antidiscrimination statutes and rules. Eligibility to participate could be tied to performance, compensation levels, or job grades or could even be decided on a discretionary basis.

Of particular use to multinational companies, eligibility to participate could be based on location or country, regardless of whether the employees in that locale are employed by the U.S. entity or a foreign entity—a challenge that plagues multinational companies that offer Section 423 plans. When a company offers a Section 423 plan, all employees of that entity must be allowed to participate, regardless of where they are located or whether they will benefit from the plan's tax-qualified status. U.S. companies that offer Section 423 plans can exclude employees of foreign subsidiaries (and parent companies) but cannot exclude employees of the U.S. entity who are located abroad.

Some countries impose restrictions (such as disallowing contributions in the form of payroll deductions) that make it onerous to offer an ESPP therein. Some countries require certain benefits to be offered under the plan (*e.g.*, requiring that employees on leave or on part-time status be offered the same benefits as full-time employees). Because of the requirement that all participants in a Section 423 ESPP be allowed to participate on an equal basis, where accommodations must be made for the laws of a particular country, those same accommodations must be extended to all other employees of the corporate entity.

Treas. Reg. 1.423-2(e)(3) permits citizens and residents of foreign jurisdictions to be excluded if participation in the ESPP would violate local laws or compliance with local laws would cause the plan to violate the requirements of Section 423. But it is rare that either of these situations occurs, and this relief cannot be relied on when local laws simply require the company to modify the ESPP in a manner that is permissible under Section 423. As a result, multinational companies that offer Section 423 plans are sometimes forced to offer the plan in countries where they would prefer not to and may be forced to offer benefits that they would rather not offer. With a nonqualified plan, however, companies could vary the benefits offered by jurisdiction and simply not offer the plan in jurisdictions that are particularly problematic.

Further advantages of nonqualified plans include that they aren't subject to the $25,000 limit (see our March–April 2010 issue at pg 6) or any limits beyond those imposed by the company's shareholders or those the company chooses to impose, and there is no need to track dispositions of shares acquired under the plan.

We're still big fans of qualified ESPPs, but we must admit that nonqualified plans have a strong allure. Particularly for companies that have a large population of employees outside the United

States, we aren't sure that it makes sense for tax advantages that benefit only one segment of their employees to drive their overall design decisions.

Tax Withholding

A significant disadvantage of nonqualified ESPPs, at least in the United States, is that the rights granted under such plans are treated as nonqualified stock options for U.S. tax purposes. Thus, companies that offer nonqualified ESPPs must be prepared to withhold federal and state taxes on purchases of stock under the plan that are made by U.S. employees. As stated above, Section 423 ESPPs rarely, if ever, qualify for preferential tax treatment outside the United States. In countries that impose tax-withholding requirements, companies generally must be prepared to withhold taxes on purchases by employees in those jurisdictions, regardless of whether the plan is qualified under Section 423. Finally, we note that some U.S. states, most notably Pennsylvania, do not align with the federal income tax code in this regard and treat ESPPs as nonqualified stock options subject to tax withholding.

SAP found an elegant solution to this challenge: matching contributions are included in income along with the compensation from which employees make contributions to the plan. Thus, the match is taxed along with employees' base pay, any required withholding can be done at the local payroll level, and the withholding is deducted from employees' pay. Because the match is taxed through payroll, the appropriate tax rate can be determined by local payroll.

SAP deducts any required withholding from employees' base pay for the period so that the full matching contribution is applied to the purchase of shares under the plan. But it would be just as easy for companies to deduct the tax withholding from the match itself, leaving employees' base pay intact. Companies that want to be especially generous could gross up the taxes on the match. (However, because tax rates vary by jurisdiction, this practice would be more of a benefit to some employees than to others. Moreover, it increases the income subject to tax in the United States and in most other jurisdictions as well and increases the company's cash outflow for the plan, possibly significantly.)

This solution works for SAP because the value of the match is not dependent on the value of the company's stock price, so there is no reason to wait until the purchase occurs to collect the tax withholding. Regardless of whether SAP's stock price is $10, $100, or $1,000, the match is always 40% of each employee's contributions, plus the €20 subsidy for nonexecutives, and subject to the €6,000 limit; there's no limit on the number of shares employees can purchase or any other requirement under the plan that might prevent the full match from being applied to the purchase of shares (and because the plan is an open-market plan, there's no concern that the plan itself could run out of shares).

The fact that purchases occur monthly under Own SAP helps out here. Any contributions made by former employees to Own SAP prior to their termination are applied to the next monthly purchase, rather than refunded. Thus, for SAP, barring some sort of rare, unforeseen circumstance, there's no chance that the match credited on an employee's contributions won't be applied to the purchase of stock.

Where terminated employees are immediately withdrawn from the plan and thus would forfeit the match, we expect that the taxes withheld could simply be refunded to employees in their final paychecks along with their unused contributions. But, where purchases occur less frequently than monthly, this practice might be problematic, especially if taxes are withheld in one calendar year and an employee's termination does not occur until the subsequent calendar year. In this scenario, the employee might not be able to recover any FICA taxes withheld. Likewise, if a plan is subject to a limited pool of shares available for purchase or imposes limits on employee purchases under the plan in addition to or instead of any limits on contributions or the match itself, such that there might be scenarios in which employee contributions would not be fully applied to the purchase of shares, withholding taxes in advance of the purchase date could be problematic.

We wonder if SAP's approach to withholding might also work for plans that offer a discount, instead of a match, provided that the plan doesn't offer a lookback and doesn't have any of the other aforementioned complications (limits on shares that can be purchased, forfeitures upon termination, etc.). A percentage discount always produces the same return (*e.g.*, a 29% discount always produces a 40% return, and a 15% discount always produces a 17.6% return). Thus, if it is certain that the discount will be realized, we don't see why it couldn't be taxed at the time contributions are deducted from employees' pay.

Lookback and a Match?

SAP's plan does not offer a lookback; with a 40% match, the plan feels more than generous without one. Sandra tells us that SAP's participation rates are in excess of 60% worldwide, a rate that most companies would be envious of (according to the NASPP's 2018 Global Equity Incentives Survey, just over half of multinational companies report worldwide participation rates of less than 40%). Thus, it is clear that SAP's employees find the plan compelling without a lookback.

It is certainly possible to offer a match in combination with a lookback—with a nonqualified plan, companies can offer just about any benefit they want. But with this type of plan, it would no longer be possible to simply withhold taxes on the match. Any additional spread at the time of purchase as a result of the lookback would be taxable. The company would not be able to predict this in advance, so this would necessitate withholding taxes at the time the purchase occurs. And, in the event of a significant increase in the price of the company's stock over the purchase period, the required withholding could exceed what can be easily accommodated through payroll.

Accounting Considerations

The fair value of an ESPP under ASC 718 is the sum of its component benefits. Where an ESPP does not offer a lookback, the expense for the plan is simply the dollar-for-dollar cost of the benefit delivered to employees, whether in the form of a discount or a match (see our May–June 2005 issue at pg 2), typically recognized over the purchase period. Sandra confirms that SAP recognizes the cost of the match in the same month that the employees' contributions are deducted from their pay.

If the plan also offers a lookback, that adds an option-like feature to the ESPP that must be valued using an option pricing model (typically, the Black-Scholes model).

Bifurcated ESPPs: Qualified in U.S. and Match Outside U.S.?

For companies that have only a small population of non-U.S. employees or are otherwise committed to a qualified ESPP for their U.S. employees, we wonder whether a bifurcated approach might be a better solution than the one-size-fits-all approach that most companies currently take. Employees in the United States could be offered a traditional Section 423 plan with a discount, and employees outside the United States could be offered a nonqualified plan with a match. Both plans could provide the same economic benefit, but delivering the economic benefit in the form of a match facilitates the tax-withholding requirements that frequently apply in the case of non-U.S. employees. (This approach is most viable when all of the company's non-U.S. employees are employees of a separate corporate entity. As mentioned above, non-U.S. employees who are employed by the U.S. entity must be allowed to participate in any Section 423 qualified ESPP offered to the company's U.S. employees.)

The cleanest approach would be to offer plans that mirror each other, except that the U.S. plan is tax qualified and offers a discount (*e.g.*, 15%) and the non-U.S. plan is nonqualified and offers a match (*e.g.*, 17.6%). Neither plan would have a lookback, and purchases would occur more frequently than is typical under Section 423 plans so that terminations don't result in forfeitures (this is permissible under Section 423 as long as the purchase occurs within three months of the former employee's termination). Without a lookback, there's no economic disadvantage to purchasing more frequently; this approach has the effect of dollar cost averaging purchases, which is arguably a better economic result than infrequent purchases. The primary disadvantage to more frequent purchases is simply administrative burden for the company.

For companies that want to provide a more equal benefit to non-U.S. employees, the non-U.S. plan could offer a greater discount to offset the taxes that non-U.S. employees will have to pay at the time of purchase. In most cases, it won't be feasible to truly equalize the benefit provided to non-U.S. employees with that provided to U.S. employees (this would likely require a different discount in every country and possibly even by employee), but offering some additional benefit to non-U.S. employees might help mitigate the disparity in value.

Or the two plans could diverge entirely, with the U.S. plan offering a lookback, 15% discount, and less frequent purchases (*e.g.*, every six months) and the non-U.S. plan offering no lookback, monthly purchases, and a match that equates to a significantly greater discount.

A Great Choice for Any Multinational Company

SAP's plan is obviously a great choice for any company looking at implementing a nonqualified ESPP, given SAP's success with it and the generally poor performance of other types of nonqualified ESPPs, as evidenced by the NASPP's survey. But we think that multinational companies that currently offer qualified ESPPs might also want to take a look at an SAP-style plan. It could solve at least four challenges they are currently struggling with: poor participation, inability of lower paid employees to participate, tax withholding outside the United States, and plan dilution.

We thank Sandra Sussman of SAP for helping us understand the mechanics of SAP's plan. We also thank Art Meyers of Choate Hall & Stewart for helping us understand the NYSE's shareholder approval requirements.

Early Bird: "Proxy Disclosure Conference"

We're excited to announce that we have just posted the registration information for our popular conferences—"Proxy Disclosure Conference" & "16th Annual Executive Compensation Conference"—to be held September 16-17th in New Orleans and via Live Nationwide Video Webcast. The agendas are posted on TheCorporateCounsel.net—20 panels over two days.

Among the panels are:

1. The SEC All-Stars: A Frank Conversation
2. Hedging Disclosures & More
3. Section 162(m) Deductibility (Is There Really Any Grandfathering)
4. Comp Issues: How to Handle PR & Employee Fallout
5. The Top Compensation Consultants Speak
6. Navigating ISS & Glass Lewis
7. Clawbacks: #MeToo & More
8. Director Pay Disclosures
9. Proxy Disclosures: 20 Things You've Overlooked
10. How to Handle Negative Proxy Advisor Recommendations
11. Dealing with the Complexities of Perks
12. The SEC All-Stars: The Bleeding Edge
13. The Big Kahuna: Your Burning Questions Answered
14. Hot Topics: 50 Practical Nuggets in 60 Minutes

Early Bird Rates—Act by April 5th: Huge changes are afoot for executive compensation practices with pay ratio disclosures on the horizon. We are doing our part to help you address all these changes—and avoid costly pitfalls—by offering a special early bird discount rate to help you attend these critical conferences (both of the Conferences are bundled together with a single price). **Register on TheCorporateCounsel.net by April 5th to take advantage of the 20% discount.**

It's Done: 2019 Executive Compensation Disclosure Treatise

We've wrapped up Lynn, Borges & Romanek's "2019 Executive Compensation Disclosure Treatise"—and it's now available online and in print. This edition includes the latest pay ratio guidance from the first year of disclosure—as well as Corp Fin's recently-updated CDIs. All of the chapters have been posted in our "Treatise Portal" on CompensationStandards.com.

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This book is designed for fairly young lawyers—both in law firms and in companies. It's written in an "easy to read" style, complete with some stories & anecdotes to make it interesting. This is a unique offering in our field—and we're pretty happy about how it came out. Members can request it now on TheCorporateCounsel.net.

—BB

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