Be prepared: A stock plan professional's guide for today's wild ride

Let's face it. We are in unchartered waters.

The unique confluence of market volatility and inflation, paired with a pretty solid job market has plunged us into unfamiliar territory. Without a functioning crystal ball, who knows what lies ahead? Apart from the blip in 2020, many of today's equity plan professionals' experience has been firmly rooted in a strong bull market. But never fear. You don't have to navigate this unfamiliar territory on your own. Equity compensation has endured through business cycles, market volatility, economic changes, and uncertainty—and still remains an important component of a total compensation strategy.

This article explores some of the learning gleaned from past cycles and, in the interest of readiness, offers six important considerations for stock-based compensation in uncertain times.

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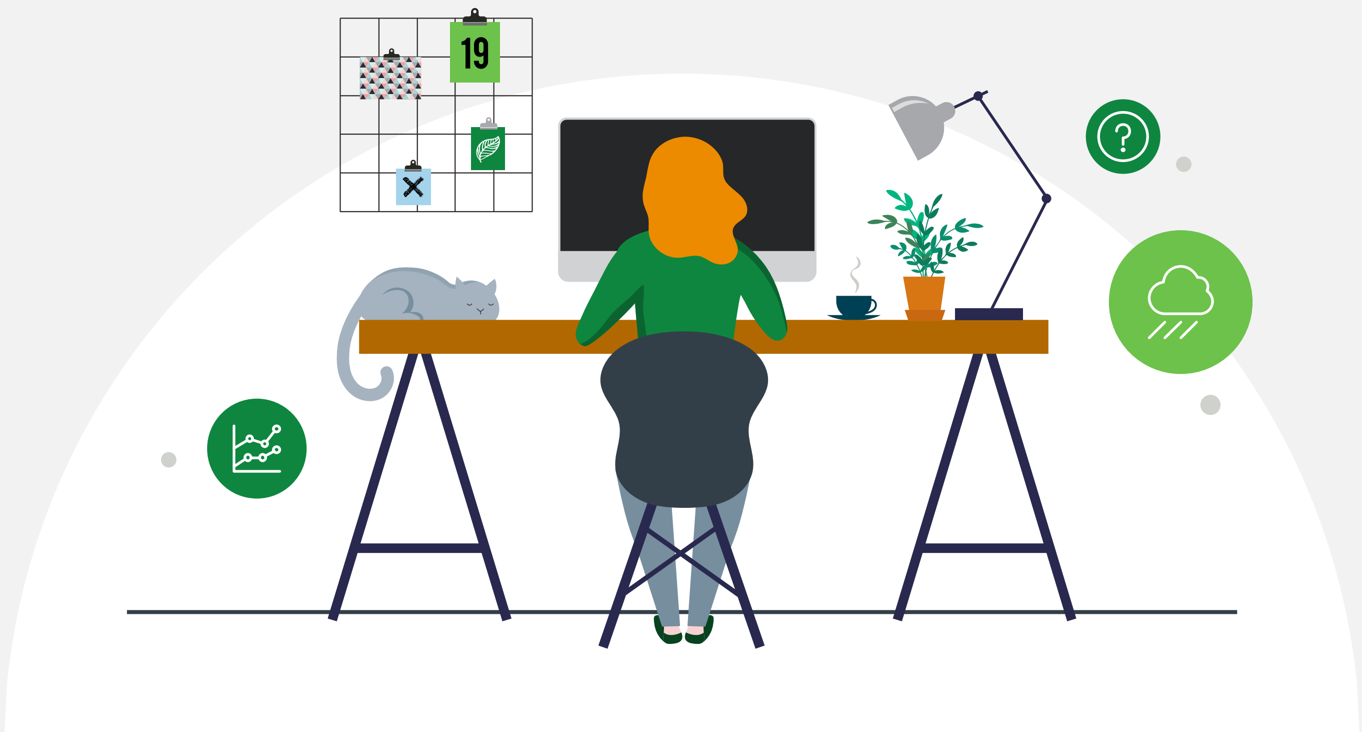


CONSIDERATION 1: STOCK OPTION REPRICING

Repricing?! Ugh. While repricing may not be a bucket-list item, it may be time for a quick primer on repricing.

Note that if your company doesn't have outstanding stock options, you get to jump the line and start at Consideration 2.

Stock options come with a price. This is known as the strike price, grant price, or option price, but regardless of what you call it, it's the price employees pay to acquire the underlying stock.

The price is generally the stock's fair market value (FMV) on the date of grant. In times of declining stock prices, options may have a strike price that's higher (potentially significantly higher) than the current FMV. For example, if a company granted stock options at an all-time high of $300 but the stock has since dropped to $75, that option is now underwater! That's a 75% drop, and those options may no longer be as effective as a retention and motivation tool.

There are a variety of ways that companies can restore value to underwater options, all of which may be characterized as "repricing". Institutional Shareholder Services (ISS) calls these "repricing actions", but regardless of the approach, repricing is easier said than done. Spoiler alert—shareholders don't get a do-over on their investments, so institutional shareholders generally aren't fans of repricing actions.

Repricing—Modifying the option to reduce the exercise price.

Cancel/regrant (aka – **option exchange**)—Employees forfeit outstanding options and the company replaces them with new at-the-money options or restricted stock.

Cancel/replace—Employees forfeit outstanding options and the company replaces them with a cash payment.

Thanks to the exchange rules, repricing actions will generally require shareholder approval, so you need to get shareholders on board. It's possible to do so, but special terms will apply. ISS has outlined some key factors that could be deal breakers when it comes to getting a favorable recommendation on repricing actions[1]:

Value neutral—Underwater options are revalued and replaced with an award at the same value. This means there are fewer replacement options and even fewer shares if replaced with restricted stock.

Share counting—Cancelled shares can't be added back to the share reserve.

Vesting—Not so fast... the vesting can't be immediate.

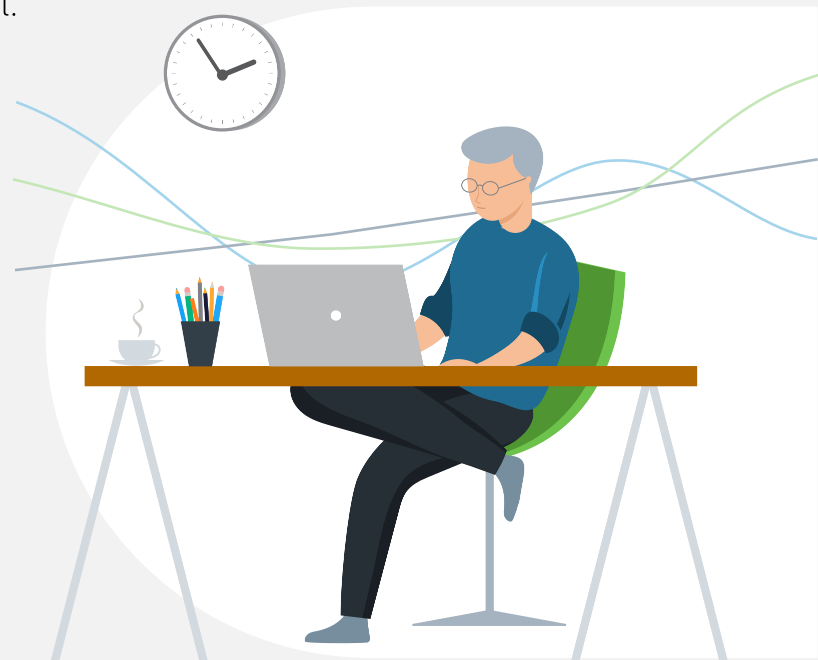
Executive officers and directors—Must be excluded.

Despite feeling pressure to address underwater options quickly, you may need to slow your roll. Repricing actions that occur within a year of a serious stock price drop aren't as likely to garner shareholder approval.

Finally, repricing actions create a big, hairy, accounting situation and often trigger tender offer rules in the U.S. Undertaking a repricing isn't for the faint of heart. You may need to consider your company and shareholder appetite for repricing in smaller bites.

CONSIDERATION 2: SHARE POOLS

You may be experiencing a dip in the pool. And we aren't talking about vacation.



Declining stock prices, as well as changes to equity strategy, can have a big impact on your share pool. Most companies grant equity awards to deliver a target value. Simple math tells us that lower share prices mean more shares are needed to hit that value, so your share pool may drain faster than planned.

Share requests typically come only once a year, so the timing can be tricky if there's a precipitous drop in price shortly after your annual shareholder meeting. And, if you're burning through shares to deliver target values, your share request and burn rate may be subject to more scrutiny from shareholders[1].

Let's look at the impact of a falling stock price on a share pool:

Consider a company that recently replenished its share pool when the stock was trading at $300. At that FMV, its modeling may have predicted that the pool would last five years.

If the stock price has declined to $75, delivering the same target value of awards could deplete the pool four times faster than planned.

And, for those of you who read Consideration 1 and are thinking about repricing stock options, remember that those canceled shares can't be returned to the pool, which may further exacerbate the depletion.

There are a few strategies that can help if a share pool will be depleted before the next shareholder meeting. Some companies may delay the annual grant until additional shares are approved. Other companies may prorate the grant, with a goal of making up the difference with an additional grant when the share pool is replenished. And others may reduce grant sizes. Some may even take on the mark-to-market accounting of cash-settled awards.

Inducement grants can be a star player in the share pool strategy. Unlike all other grants, inducement grants don't have to be made from a shareholder-approved plan. This can be a relatively easy hack to extend the life of your share pool, but inducement grants are not a panacea for all share shortfalls.

There are several caveats on these inducement grants, including:

Inducement grant caveats

New employees only

These aptly named grants must *induce* employment, so this is only available for new employees.

Induce to accept

The grant must be a material inducement to the individual accepting the job.

Eligibility

Contractors, advisors, and non-employee directors aren't eligible for these grants because they're not deemed to be employees.

Press release

Inducement grants must be disclosed through a press release. For executive officers or individually negotiated inducement grants, an immediate press release is required. Routine inducement grants to new hires without individual negotiation can be bundled in a press release no less frequently than every two weeks.

Given all of these caveats, Section 16 officers may be your best bet for inducement grants; public disclosure of compensation is expected at that level and the grants are typically big. There are a few other requirements for inducement grants, so be sure to connect with your legal advisors before pursuing this strategy.

Regardless of economic conditions, good share pool hygiene includes routine modeling of different scenarios to identify any share pool concerns with enough time to react. During periods of uncertainty, share pool modeling may need to increase in frequency and/or scenario span.

CONSIDERATION 3: GRANTING PRACTICES

Companies granting stock options aren't the only ones concerned about the effectiveness of equity compensation in a volatile or down market. The value of restricted and performance awards may look very different compared to when granted. There are a couple of specific considerations for mitigating unexpected outcomes.

Multiday averages

Shifting from a spot price to a multiday average for grant sizing can soften some of the sharpest peaks (and valleys) of share usage in volatile times.

How does this work?

Most companies grant a target dollar value.
More than 70% of companies convert target dollar values to shares using a spot price, which uses a single-day price, usually on or near the grant date.[2]

While that may seem like a good idea, a poorly timed, sudden market shock could send your price plummeting (or skyrocketing) on that day, which can materially impact the number of shares required to fulfill the grant.

Further, a spot price may unfairly penalize (or privilege) some employees by increasing or decreasing granted shares based on short-term stock movement.

A multiday average is just what it sounds like. Stock grants are determined using the average stock price over a longer period of time. Even a short, five-day average will help smooth the impact of share price volatility, but a 60- or 90-day average may provide more insulation from sharp stock change prices for your share pool and employees.

While a multiday average can be used in determining grant size, the grant date FMV will still be used to determine the strike price for stock options and for calculating compensation expense.

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Relative awards

While the saying goes you can't pick your relatives, you can pick to grant relative awards!

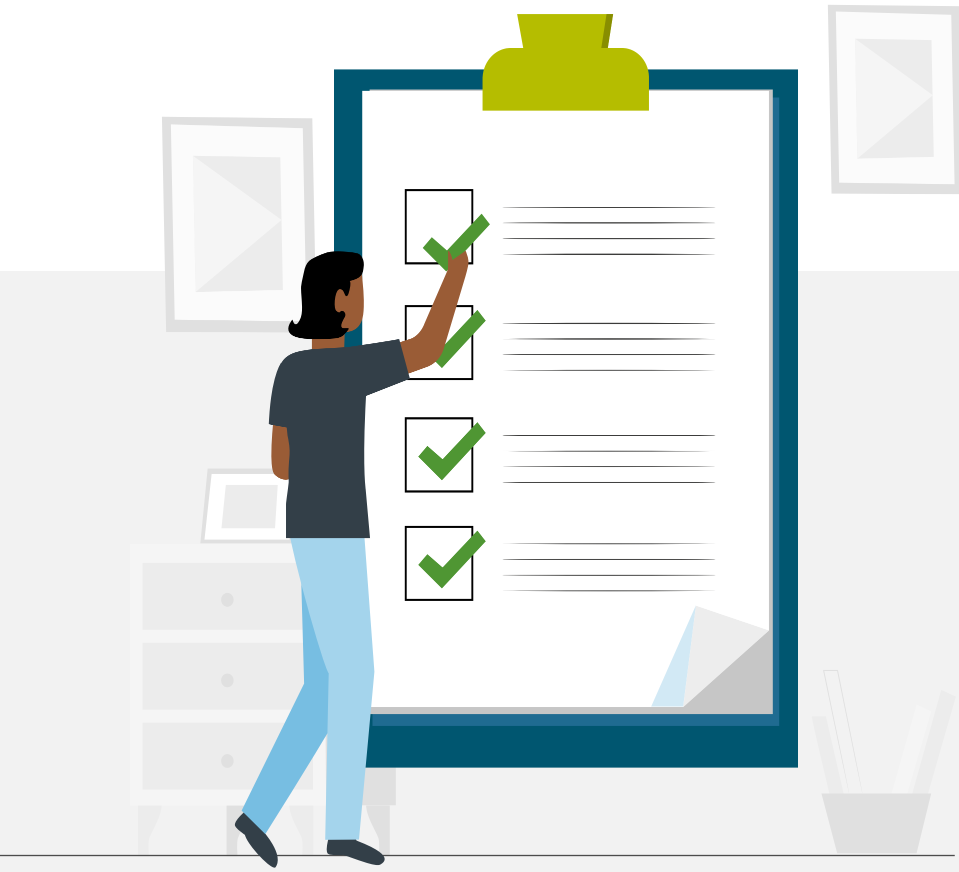
Goal setting for performance awards in uncertain economic times is hard.

Multiyear goal setting is even harder. If the economic environment results in goals that are no longer achievable, the performance awards may not be enough to motivate and retain executives.

Companies can simplify the goal-setting process and establish targets that adjust to changing economic times by granting performance awards with relative, rather than absolute, targets.

Relative targets pin the performance metrics to your performance relative to a group of peers, rather than absolute benchmarks.

While a rising (or lowering) tide impacts all ships, a relative measure can be a good way to align pay based on performance against peers rather than relying on metrics that can be impacted by economic factors outside of an executive's control.



Many companies have already seen the advantages of relative awards by including relative total shareholder return (TSR)[3] as one of the performance metrics. But this same principle can be applied to other performance metrics as well, including revenue goals, earning targets, and other common performance metrics.

While granting relative awards may simplify the goal-setting process, there are still important considerations in designing an effective plan, including selecting the appropriate metric, defining the right peer group, and mapping out the correct measurement period and distribution schedule.

Special retention awards

In more difficult economic environments, companies are generally watching every penny. However, having the right teams in place to guide your organization is as critical as ever, and strategic investments to encourage retention, loyalty, and productivity may pay off in the long run.

A strategy to consider is granting targeted special retention awards to critical individuals or even broader retention awards to teams or key populations.

These grants can serve to incentivize and reward these individuals, as well as to make up for share value that was lost due to declining stock prices and/or underwater options.

By providing these awards at a lower stock price, companies may also be in a position to deliver greater rewards to these individuals when the organization and markets return to prior levels, particularly if delivered as stock options.

IMPACT

Special awards such as these are subject to many of the same considerations that are outlined above.

These additional awards ***will*** impact your share pool—and at a time when this pool may already be tight. And, of course, there's the additional expense and dilution associated with the grants themselves.

COMMUNICATION

Careful messaging and communication of any special awards should be front and center in your strategy.

If and when other aspects of the organization may be getting cut back, the tone and manner of the deployment of these awards will be critical to ensure that they aren't viewed poorly by the broader employee populations or the marketplace.

CONSIDERATION 4: ESPP

Employee Stock Purchase Plans are the most common way to offer ownership on a broad basis.[4]

ESPPs often have built-in discounts or matches that help them weather stock price volatility better than some other equity types. Even so, there are important considerations in operating and communicating an ESPP in an uncertain environment.

REFUNDS

Most ESPPs in the United States are tax qualified under Section 423[5]. The $25,000 purchase limit in Section 423 plans is calculated using the FMV at the beginning of the offering. When employees purchase stocks that are declining in price, they may contribute more than required, resulting in an unexpected refund of contributions at the end of the purchase period.

For most plans, it's more likely that employees will run into this limit with purchases in the second half of the year. Plan sponsors need to ensure that employees understand how this limit works so that they can adjust their contribution amounts accordingly, particularly when a $25,000 limit carryover occurs in non-calendar-aligned ESPP purchase periods.

Decreasing contribution rates during an offering won't provide any compensation expense reduction.

For example,

If the first offering period of the year starts with the stock trading at $300 and the plan offers a 15% discount and lookback, per the IRS $25,000 limit, an employee can only purchase 83.33 shares ($25,000/$300).

An employee can purchase those 83.33 shares by contributing $21,250, – and some employees will define their contributions to target this level.

However, if the stock price drops during the purchase period, which will reduce the purchase price of the shares, employees will still be limited to purchasing 83.33 shares, and the remaining amounts will be refunded to them.

Below is a table outlining the refunds that would apply based on certain stock levels:

Employee Contributions	Stock Price at End of Period	Shares Purchased	Cost of Shares (Reflecting a 15% discount)	Refund to Participants
$21,250	$300	83.33	$21,250	$0
$21,250	$250	83.33	$17,708	$3,542
$21,250	$150	83.33	$10,625	$10,625
$21,250	$75	83.33	$5,312	$15,938

As you can see, the further the stock price drops, the greater the refund to the employee. In this scenario, if the stock plummets to $75, it'll result in a refund of nearly $16,000!

SHARE POOL

As mentioned above, share pool concerns pop up with ESPP as well. With a lower stock price, in most cases, more shares will be purchased under the ESPP, potentially depleting your share pool sooner than anticipated.

Approaches to consider:

- Review your plan reserve and update models on share usage to calculate the expected life of your plan. Calculate how long your share pool will last at current pricing.
- Companies may consider instituting a share limit or dollar contribution limit to manage its share reserve or may proportionally cut back employee purchases.

Each approach will yield different results based on a fluctuating stock price, and all approaches may make the ESPP a less attractive program to impacted employees.

Organizations that are considering implementing these sorts of limitations should plan to do so for an upcoming offering period, and clearly communicate this approach in advance of the purchase period so that individuals can evaluate their participation and contribution levels appropriately.

RESETS AND ROLLOVERS

ESPPs that have multiple purchases in a single offering (sometimes referred to as "Cadillac" plans) are in the minority of ESPP plan designs[6], but they have important considerations in a down market. For employees, a reset or rollover can be a great benefit but may be confusing.

In multiple-purchase arrangements, when the stock price declines, the reset may be triggered to give employees the benefit of the lower price.

The FMV used to calculate the purchase price in the reset offering will be lower, allowing employees to purchase shares at a lower price up to the value of the entire new offering.

Communicating this, and the fact that employee action is not required, is important so that the employees understand the benefit they're receiving.

After all, the reset is intended to create more value for employees.

From an accounting perspective, here again we are dealing with a complicated modification accounting scenario. An analysis needs to be performed to determine the incremental expense created by the reset. Because it's a Type I: Probable-to-Probable modification, the original grant date expense stays intact and the modification expense is recognized in excess of that original amount over the new offering period.

EMPLOYEE (AND EMPLOYER!) CONCERNS

Many employees may wonder if an ESPP continues to make sense in a down market.

Employees

Because most ESPPs offer a discount so even during a market decline, the price employees pay is typically less than the FMV of the company's stock on the date of purchase.

Employees with a long-term view may see a down market as the perfect time to buy because of the potential growth in value when the market recovers and because they can generally purchase more shares with their contributions when the price is low (subject to plan limits).

With frequent purchases, ESPPs are an effective way to invest at regular intervals, and, with the price down, the benefits of dollar-cost averaging through regular investing become more apparent.

Employers

Employers may also see a benefit of maintaining the ESPP during a down market because it can offer value to employees without straining company cash resources and it's typically more cost effective than traditional stock-based compensation.

The ESPP also generally provides a source of cash inflow to the company as employees pay to purchase shares that are funded through original issuance or Treasury shares.

ESPPs can be an efficient cash and expense tool to motivate broad-based employees, particularly if other benefits or cash compensation are being reduced. However, compensation expenses may be more difficult to justify during challenging economic times, and, in some companies, participation declines may be projected to be so significant that the administrative overhead of maintaining an ESPP no longer makes sense. There are many questions and company specifics involved in making decisions about your ESPP during a declining market.

CONSIDERATION 5: EMPLOYEES

Sometimes stock plan professionals can get so bogged down in rules, numbers, compliance, and regulatory considerations, that we may not always focus on what really matters—our employees.

Employees are the center of the stock plan universe

Align

Most companies grant equity awards not for the fun of the accounting or the appeal of the regulatory filings, but to attract, retain, motivate, and align employees.[7]

Service

Remember to keep employees front and center in uncertain times.

Assist

Employees may need help understanding how to manage through difficult economic times.

Support

And, if it comes to it, employees facing a layoff or redundancy may need help through the transition.

EDUCATE ME

Market volatility and sharp declines rattle even the most experienced holders of equity compensation. Many employees, especially those who are new to the stock grant experience and who've seen their company's stock prices over the last decade mainly increased, may find that they aren't fully prepared to cope with the emotional toll caused by the impact of market volatility on their equity compensation. The failure of companies to communicate during times of market volatility is a missed opportunity to help employees gain a greater understanding of their value to the employer as well as how equity award value may ebb and flow with the market.

An established financial plan that incorporates stock grants can serve as a trusty guide through volatility. For employees who don't have a financial plan, creating one now can help guide them through challenging times, as well as through market recovery.

This may also be an opportune time to address the long-term nature of these incentives. Options that are underwater still have value if a lengthy contractual term remains. And, when the stock price is down, employees benefit from a lower price on newly granted options. Restricted stock continues to deliver value, albeit perhaps less than employees originally anticipated, and, like options, the grant size may increase in a down market. ESPPs are often designed to provide some protection from market volatility.

HELP ME

Changing economic times may impact staffing levels and budgets, which could result in layoffs or redundancies. While this is never a fun time, there are important ways to help impacted employees.

- Plan rules—Employees who change or lose their job need to understand how long they're permitted to exercise vested, in-the-money stock options as well as the implications of holding the stock after option exercise or restricted stock vesting.
- Acceleration of vesting—Some plans provide for an acceleration of vesting for stock options and/or restricted stock in the event of a reduction in force.

CONSIDERATION 6: EQUITY PLAN TEAM STAFFING

Let's be frank. Equity plan staffing is lean. Really lean.

Last, but certainly not least, we should talk a bit about your own equity plan staffing needs.

More than half of companies manage their equity plans with the equivalent of fewer than two full-time staff members. It's rare for companies to have the equivalent of more than three full-time staff members. And more than 40% of organizations report that staffing levels aren't sufficient.[8]

Turnover in small teams can be painful because there are limited resources to take on the extra work. Whether turnover is the result of promotions, layoffs, redundancies, or job changes, it can present a challenge.

Don't despair. There are some ways to mitigate these risks.

Outsourcing

Companies that outsource transaction processing are more likely to feel sufficiently staffed than companies that don't. RSUs, PSUs, and ESPPs create major volatility with respect to the draw on equity plan resources. It may not be practical to staff according to transaction volume peaks that only occur on an annual or quarterly basis. Companies that outsource to manage these peak transactions may be better equipped to weather changes in their equity plan staffing.

Available resources

Your existing service providers are in the business of supporting your stock plans. Are you taking advantage of everything that's available to you? Capabilities, offerings, and products may have expanded since you last checked. Consider conducting an audit with your service teams to make sure you're getting the most out of your providers. Working with an outsourced provider that serves as an extension of your organization can mitigate risk and help ensure compliance regarding complex processes.

Training

Take advantage of training opportunities. Training can help ensure that your teams are effectively using the tools they have, and it helps to accelerate the onboarding of new team members. It may also be appropriate to train backup resources, so you have support in case roles or responsibilities change.

Quick tips for Fidelity Stock Plan Services clients

- The Standard Operations and Resources playlist located in the SPS Video Library is a useful tool for accelerating the training of new team members as well as backup support.
- Distributions, grant loads, ESPP purchase confirmations, and other processes require PSW approval. All team members, including backups, should be trained on the approval process, including specifics about financial reporting approvals.
- Ensure that you have identified a backup and enable PSW access that mirrors primary contact access, including plan reporting, financial reporting, and approvals. Also ensure that there is at least one designated superuser within your administration team who can create login credentials for PSW access for new users, and financial reporting users, as necessary.
- Document monthly/quarterly PSW plan reporting and financial reporting, including how to run those reports, to ensure that your teams, backups, and any new hires are in a position to support you.

WE'RE HERE TO HELP

As we head into whatever tomorrow may hold, we hope these six ideas help you prepare for what's to come. Contact your Fidelity Stock Plan Services representative to learn more about how we can support you.

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[1]2021 ISS US Equity Compensation Plans FAQ

[2]2019 NASPP/Deloitte Consulting Stock Plan Design Survey.

[3]2021 NASPP/Deloitte Equity Incentives Design Survey.

[4]2020 NASPP/Deloitte Stock Plan Administration Survey and 2021 NASPP/Deloitte Equity Incentives Design Survey

[5]83% of ESPPs in Fidelity 2022 ESPP Data Analysis are tax qualified under Section 423.

[6]Per NASPP 2020 Domestic Stock Plan Administration Survey only 8% of qualified ESPPs have a 24-month offering period.

[7]NASPP 2019 Domestic Stock Plan Design Survey

[8]2022 Fidelity/NASPP Equity Compensation Outlook survey on stock plan staffing.

Fidelity Stock Plan Services, LLC provides recordkeeping and administrative services to companies' equity compensation plans.
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