THE INS AND OUTS OF EQUITY COMPENSATION PLANS: PUBLICLY HELD COMPANIES

WHAT IS IT?

Equity grants are one way — other than cash — that employers can reward and compensate employees. Since the 1990s, the use of equity compensation has expanded for a range of employees in both pre-IPO and publicly held companies. *This piece focuses on publicly held companies*.

Stock options began as the most common equity compensation grant. But grants have evolved into two types based on how an employee acquires the stock: either by an employee action (exercising an option) or the stock is delivered upon vesting (restricted stock).

Exercisable:

- The grant can take the form of nonstatutory options (sometimes called nonqualified stock options), incentive stock options (ISO grants are uncommon except for pre-IPO companies) or the less common stock appreciation rights (SAR).
- To acquire the stock, employees exercise the option at the preset price, which is generally close to the fair market value (FMV) of the stock when it's granted.
- Grants have a three- or four-year vesting schedule and a 10-year expiration period after which unexercised options generally expire. Some companies have begun to reduce expiration periods to five or seven years.

Restricted:

- The grant can take the form of restricted stock awards (RSAs), restricted stock units (RSUs), or performance share units (PSUs).
- To acquire the stock, the restriction, which is either time-based (RSA and RSU), or time and performance-based (PSU) must have lifted. Performance units could pay out in stock, cash or both.
- If the recipient is employed when the restriction lifts, they acquire and fully possess the vested stock.
- A common vesting schedule is three years.
- Time-vested grants generally use graded vesting.
- Performance-based grants are usually cliff vested at the end of a three-year period — if the performance hurdle has been met.

WHO PARTICIPATES?

- Companies can offer equity award grants to employees of all levels; some companies offer equity compensation to employees in the general population.
- C-suite employees and top executives are more likely to receive a mixture of grants: performance share units as well as options and restricted stock unit awards.
- Highly compensated employees are more likely to get restricted stock units and perhaps some stock options.
- A newer twist is allowing highly compensated employees and executives to defer receipt of vesting RSUs and PSUs into a company-sponsored nonqualified deferred compensation plan.

HOW DOES IT WORK?

Employees who are awarded grants should view them in two ways:

1. As W-2 compensation if the stock is acquired, subject to the same tax treatment as cash compensation.
2. Once acquired, as a personal investment that can be sold for a gain or a loss like any other listed stock.

Note: *Depending on the employee's band (seniority), there may be requirements to hold a certain amount of the stock.*

The W-2 wage component is determined differently between the two types:

1. When an option or stock appreciation right is exercised, the spread (difference) between the exercise price and the fair market value is added to an employee's W-2 wages for the year.
2. When an RSA, RSU or PSU vests, the fair market value (at delivery of the stock) is added to the employee's W-2 wages for the year.

Note: *In both cases, that amount is subject to federal, state and local income taxes, as well as any applicable payroll taxes.*

The cost basis of the stock upon acquisition is the same for both stock options and restricted stock. It's the fair market value of the stock at the time the stock is acquired.

COMMON QUESTIONS

Q: How will I know if I receive an equity grant?

A: You'll receive an award letter or certificate detailing the type and form of the grant, the amount of options or units, the vesting schedule and any applicable expiration period. The grant letter may include general rules as well as any rules applicable to the employee's band (seniority) in the company. There may also be an overarching stock plan document that outlines the scope of what the company can offer and its general rules. Most companies now have stock plan administration websites where you can view the history of all your grants, download reports and exercise vested options.

COMMON QUESTIONS (continued)

Q: If I receive a grant, am I guaranteed to acquire the company stock?

A: You must be an employee of record when the grant vests (there can be exceptions for change of control, death, disability or separation at retirement age). For restricted stock grants, separation from service before vesting means forfeiture of at least a portion of or all of the grant. For exercisable grants, stock acquisition requires vesting, a remaining expiration period and the exercise of an option. At separation, you must exercise any vested options in the prescribed window of time after separation or they are forfeited.

Q: How is the amount of W-2 income determined when I acquire company stock through a grant?

A: ***For restricted stock grants,*** the fair market value (FMV) of the stock when it is delivered is W-2 compensation.

Ex: An RSU grant delivers 500 shares at $40 a share in FMV. 500 shares x $40 a share = $20,000 in compensation added to your W-2 income for the year.

Note: *You could have partial vesting of as many as three or four RSU grants in a single year.*

For option grants, if you exercise an option, the spread between the exercise price and the fair market value of the stock is W-2 income.

Ex: An exercise price of $10 x 1,000 exercised options at a FMV of $60 per share. The spread is $50 ($60 - $10). $50 x 1,000 shares = $50,000 in compensation added to your W-2 income for the year. **There is also a cost to acquiring the stock.** In this example, the $10 exercise price x 1,000 options = $10,000 in acquisition cost.

Note: *Your company may offer several ways to cover acquisition cost and withholding. These range from cash, a stock swap using shares you own or a net exercise where shares are sold to cover the withholding and acquisition (the net is delivered as the remaining shares or sold for cash, whichever you elected).*

Q: If I acquire company stock through a grant, does the company withhold taxes?

A: Yes. A minimum of 22% withholding is required for federal taxes unless the value is more than $1 million, in which case the withholding for the portion above $1 million is 37%. The company will generally withhold for state income tax and applicable payroll tax. Your employer may offer you ways to keep more shares (see above).

Q: What is the difference between graded and cliff vesting?

A: Graded means partial vesting in scheduled increments. Cliff vesting means “all at once” vesting at a point within or at the end of the vesting schedule. Grants can have an element of both, starting with a cliff vesting followed by a graded vesting schedule. This is more likely used in pre-IPO companies.

COMMON QUESTIONS (continued)

Q: How are things different in an equity compensation plan between a publicly held company and a pre-IPO private company?

A: There are several things that differ.

	Pre-IPO company	Publicly held company
Liquidity	▪ Stock is illiquid (limited ability to sell)	▪ Stock is listed on a public exchange
Sales restrictions	▪ Post-IPO lockup period of 3–6 months ▪ Required company buybacks	▪ Holding requirements for executives ▪ Company-imposed blackouts
Options	▪ Incentive stock options and nonstatutory options ▪ Some grants offer early exercise of options before vesting	▪ Nonstatutory options are most common ▪ Stock appreciation rights are less common ▪ Only vested options are exercisable
Restricted stock	▪ RSAs and RSUs are used ▪ RSUs can have a double restriction, time vesting and an event (change of control or an IPO) ▪ Stock delivery after the restriction is lifted varies from plan to plan ▪ The RSUs may have an expiration period where the grants are forfeited if double restriction is not lifted	▪ RSUs have become the type of award in public companies, with RSAs in a diminished role ▪ Time vesting alone is most common with stock delivery soon after vesting ▪ Executive employees may receive performance share units with three-year cliff vesting where a performance measure must be met to receive the stock, cash or a combination of both ▪ PSUs grants have evolved from one measure – fixed. Fixed is an all or none based on if the measure is achieved. A new format is variable where the grant amount is 100% of the performance goal, but based on how well the performance metric is met, the recipient could receive as much 200% of the grant amount or as little as 0%

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