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**Letter of Comment No: 2071**  
**File Reference: 1102-100**

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***RE: Proposed Statement, Share-Based Payment (the "proposed Statement")***

To Whom It May Concern:

This letter is in response to the Financial Accounting Standards Board's (the "Board") invitation for comments on the proposed Statement. In particular I am commenting on the Board's Issue 6 related to Employee Stock Purchase Plans ("ESPPs").<sup>1</sup> Please note that this comment letter reflects my personal opinion and not necessarily the opinion of my employer or the other attorneys with whom I work.

I am an attorney who has practiced in the area of employee benefits, including (but not limited to) equity compensation, since 1996. Nearly all of the public companies that I have worked with sponsor an ESPP.<sup>2</sup> It is my and, I believe, my clients' strong belief that ESPPs are a valuable employee benefit and recruiting and retention tool.

Issue 6 – Employee Stock Purchase Plans

I respectfully disagree with the Board's conclusion that ESPPs should be considered compensatory even though I do not necessarily disagree with the Board's conclusion in paragraph C77 that participation in an ESPP "derives from the employment relationship and is

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<sup>1</sup> For purposes of this Comment Letter, references to Employee Stock Purchase Plans are references to employee stock purchase plans that receive favorable tax treatment because they comply with all of the requirements of Section 423 of the Internal Revenue Code of 1986, as amended (the "Code") in form and in operation.

<sup>2</sup> The NASPP/PricewaterhouseCoopers 2000 Stock Plan Design and Administration Survey reports 61.7% of the 345 companies that participated in the survey sponsor an ESPP.

unrelated to a possible role of employees as holders of equity instruments.” Notwithstanding the foregoing, I strongly believe that all ESPPs should be considered not compensatory.

The Board states in paragraph C77 that it “sees no reason to account for share purchase plans differently.” I submit that there is a strong public policy reason to account for ESPPs differently. Congress recognized this public policy when it enacted Code Section 423 giving ESPPs favorable tax treatment and the Internal Revenue Service recognized it again more recently when it determined that income and employment tax withholding is not required upon the purchase of shares under an ESPP. I believe the relevant public policy here is two-fold: (1) encourage employee ownership and (2) encourage broad-based employee benefit plans.

I believe that there are three main reasons why ESPPs should be accounted for differently:

- ESPPs are approved by the stockholders of the plan sponsor;
- The benefits available to employees under ESPPs are substantially limited by Code Section 423; and
- ESPPs are broad based employee benefit programs.

### **Stockholders Approve ESPPs**

Code Section 423 requires that all ESPPs be approved by the stockholders of the plan sponsor. Moreover, the NYSE and NASDAQ listing rules require that ESPPs qualify under Code Section 423 or otherwise be approved by the stockholders of the plan sponsor. If stockholder-investors believe that ESPPs when treated as not compensatory are detracting from their ability to value the employer or that ESPPs are a cost hidden from the financial statements, then let the investors refuse to approve ESPPs. ESPPs should not be considered compensatory and thus possibly eliminated as a viable employee benefit program<sup>3</sup> simply to protect the stockholder-investors who generally treat ESPPs favorably. This favorable treatment is based, at least in part, on the fact that the dilutive impact of ESPPs is limited (see the discussion of such limits imposed by Code Section 423 below). In fact, ISS has come out generally in favor of ESPPs.

### **Code Section 423 Limits the Dilutive Effect of ESPPs**

In order to qualify for the favorable tax status afforded ESPPs, an ESPP must comply in form and in operation with the requirements of Code Section 423(b). Although one could argue that all or nearly all of the nine requirements set forth in Code Section 423(b) limit the dilutive effect of ESPPs, I will discuss the two key requirements in this comment letter.<sup>4</sup> First, Section

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<sup>3</sup> Oracle Corporation announced on March 31, 2004 that it would terminate its ESPP if it was required to expense it.

<sup>4</sup> Congress imposed a series of rules and limitations on ESPPs when it enacted Code Section 423. Congress’s treatment of ESPPs is akin to its treatment of incentive stock options and qualified retirement plans. For example, ESPPs and qualified retirement plans both receive tax favored status because Congress concluded there was a strong public policy to afford this status to these programs, but as a quid pro quo ESPPs and qualified retirement plans are

423(b)(3) requires that no employee can participate in an ESPP if such employee, immediately after the receipt of an option under the ESPP, would own 5% or more of the stock of the employer (on an aggregate basis including options). This requirement limits dilution by not permitting individual employees to purchase a concentrated amount of the employer's stock through the ESPP. This 5% limitation plays another key role, however. By not allowing 5% holders to participate in the ESPP, employees who are in a position to influence a stockholder vote or otherwise influence the management of the employer are excluded from participation in the ESPP. This is not to say the executive officers who hold less than 5% of the employer's and are otherwise eligible to participate in the ESPP do not influence the management of the employer. The point is that the ESPP has built in controls with respect to employees who also hold a substantial amount of the stock of the employer.

The second statutory requirement that limits the dilutive effect of ESPPs is the \$25,000 limitation found in Code Section 423(b)(8). Specifically, no employee may be granted an option which permits his rights to purchase stock under ESPP to accrue at a rate which exceeds \$25,000 for each calendar year in which the offer is outstanding. The \$25,000 limitation often severely limits the number of shares that can be purchased under the ESPP.

In addition to the statutory limits, many employers impose additional limitations on the ESPPs in order to limit the dilutive effect of the plans. For example, employers limit the percentage of compensation that can be deferred under the plan and some employers further limit the definition of compensation so that deferrals from cash bonuses and overtime cannot be made under the ESPP. Some employers place a hard limit on the number of shares that can be purchased on a purchase date or during an offering period.

These statutory limitations, the other seven statutory limitations imposed by Code Section 423 (not discussed in this comment letter) and the employer imposed plan limitations, along with the check and balance of requiring stockholder approval of ESPPs, all limit the dilutive effect of ESPPs and thus support the conclusion that a public policy exception from the definition of compensatory plan is appropriate for ESPPs.

### **Broad Based Employee Benefit Plans Should be Considered Not Compensatory**

ESPPs are by definition broad based employee benefit programs. Code Section 423(b)(4) requires that all of the employees of any corporation whose employees participate in an ESPP must be eligible to participate in the ESPP with three limited exceptions.<sup>5</sup> The broad based feature of ESPPs was likely a factor that led the Board to conclude that ESPPs should not be considered compensatory under APB 25. More importantly, the broad based feature of ESPPs

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required to be broad based plans and Congress has imposed certain limits on the benefits that can be received under these plans.

<sup>5</sup> The three exceptions to the mandatory eligibility requirement under Code Section 423(b)(4) are part-time employees, seasonal employees and highly compensated employees.

seems to be a factor in the determination that certain ESPPs are not compensatory under the proposed Statement.

It is counter-intuitive to me that the broad based feature of ESPPs should be a factor in determining that the plans are not compensatory unless the Board is specifically making an exception for ESPPs from the definition of compensatory plan. Specifically, assume that none or very few of an employer's employees own employer stock outright. Assume further that the employer sponsors a program under which all stockholders and all employees may purchase shares under the same terms and conditions from the employer on a specified purchase date. This program would be considered not compensatory under the proposed Statement. But note that the only reason that the employees are permitted to participate in the program is that they are employees. Since the employees are not stockholders, their participation in the hypothetical program is necessarily based on "the employment relationship and is unrelated to a possible role of employees as holders of equity instruments" as stated in paragraph C77 of the proposed Statement. The hypothetical program appears to be the epitome of a compensatory plan. Therefore, in determining that this hypothetical program is not compensatory, the Board must be making a policy decision that broad based programs deserve to be treated differently. I strongly urge that the Board to recognize that the broad based feature of ESPPs together with the fact that ESPPs are approved by the stockholders and benefits are limited under Code Section 423 are sufficient reasons to reach a policy based decision that ESPPs deserve special treatment and should be considered not compensatory for financial accounting purposes.

#### Roundtable Attendance and Additional Clarification

Finally, please consider my request to attend the roundtable discussion to be held in Palo Alto, California on June 24, 2004 so that I may be included in any discussion regarding the treatment of ESPPs in the final statement. I, along with two additional speakers, am schedule to speak at the National Association of Stock Plan Professionals (NASPP) national conference to be held in October. Our presentation is titled "Employee Stock Purchase Plan Design after Option Expensing." In order that we may present the best program possible, I would like to attend the roundtable discussion so that I have first hand knowledge of the Board's reasoning behind its treatment of ESPPs. To the extent that I am unable to attend the roundtable discussion, I request that the Board provide additional guidance on ESPPs prior to the release of the final accounting rules so that employers have time to plan for the impact of the new rules. Specifically, I would request clarification on the following issues:

- Under the proposed Statement, are all ESPPs considered compensatory if the stockholders are not given the same opportunity to purchase additional shares on each purchase date under the ESPP?
- If the answer above is no, would the fact that employees typically do not pay brokerage fees on purchases under ESPPs result in the treatment of the ESPP as not compensatory if stockholders were not also given the opportunity to purchase shares without paying brokerage fees?

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Thank you for your consideration in reviewing this comment letter. I am at your disposal if you wish to discuss any of these issues further.

Very truly yours,

/s/ Alison E. Wright

Alison E. Wright

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