Retirement Eligible Employees and “Implicit” Holding Periods

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Current Market Practice

To reward long-term employees, many companies accelerate vesting of stock-based compensation upon retirement. Consequently, awards granted to retirement eligible participants are actually vested on the date of grant even though the underlying shares are not distributed until the nominal “vest date”. This is sometimes referred to as continued vesting. We will use the following example throughout the remainder of this article.

> *Example: A retirement eligible employee of age 60 receives 1,000 restricted shares with 3-year cliff vesting. Even if the employee retires any time after the grant, the employee does not forfeit the awards and receives the underlying shares on the 3rd anniversary.*

Because there is not a risk of forfeiture on the grant date, there is no requisite service period and all of the accounting cost should be recognized immediately upon the date of grant. However, even though the awards are vested, the underlying shares are not freely tradable for three years, and therefore these shares are inherently less valuable than shares that are trading in the open market. Effectively, these awards have an “implied” holding period written into their terms and provisions and the accounting expense should be discounted for the illiquidity during the implied holding period.

The Retirement Eligibility Analysis

There are several widely accepted valuation models for estimating the discount for illiquidity during a holding period, the most prominent of which are the Finnerty and Chaffe models. The appropriateness of each model is based upon each company’s individual facts and circumstances, such as the duration of the holding period and the volatility of the underlying shares. The estimates developed using these valuation models are verified by empirical data as seen in transactions under Rule 144.

However, the facts are not always as simple as those presented in Example 1. Most importantly, the duration of the implied holding period may change from employee to employee. Our 60-year old employee in Example 1 was retirement eligible immediately and had a three-year implied holding period, but what if there was another grantee who was 59-years old and not yet retirement eligible? If this employee becomes retirement eligible in one year at age 60, she will have one year of vesting followed by a two-year implied holding period. Shares with a two-year implied holding period will have a different illiquidity discount than a three-year implied holding period. Intuitively, shares with a two-year implied holding period are more valuable than shares with a three-year implied holding period, so the awards will have different fair values. Ultimately, all employees who

will become retirement eligible during the vesting period have a different implied holding period, and therefore a different illiquidity discount and fair value.

To properly perform these valuations, we must bifurcate all employees who will become retirement eligible over the course of the vesting period from those who are retirement eligible on the date of grant. From here, we generally see two (2) alternative approaches:

1) Create a weighted average implied holding period and illiquidity discount for the retirement eligible and soon-to-be retirement eligible population. The benefit of this approach is to yield simpler disclosures for the retirement eligible population, however, it would generally take more time to perform the valuations.

2) Calculate distinct implied holding periods for each member of the retirement eligible population. Theoretically this is the most precise approach to perform the valuation. However, it could be more complicated to explain the differences in fair value for Named Executive Officers that are disclosed in the Proxy.

Both approaches are valid and would result in nearly identical compensation expense in the aggregate. The more important consideration is consistency with prior years, and the effect on disclosure of the Named Executive Officers.

Net Effect on Compensation Expense

The net reduction in compensation expense will be a function of several factors:

- Percentage of Shares granted to Retirement Eligible Employees
- Duration of Implied Holding Period
- Expected Volatility of Underlying Share

The compensation expense discount we see for individual companies generally ranges from 10% to 15% for the retirement eligible employees (and potentially higher for more volatile companies). The discount could lead to two possible outcomes:

1) A larger number of awards granted if using ASC 718 valuation results for grant sizing; or
2) A material reduction in compensation expense for your retirement eligible population and a valuation more in line with employee perceived value.

Next Steps

Accurate valuation of equity awards is critical for disclosure of compensation expense in financial statements, and to appropriately measure the return on your compensation dollars. Valuation techniques that consider all nuances of your awards could lower the fair value and unlock significant benefits for your company.

If you would like to discuss how we can help you determine the fair value of your illiquid shares for your retirement eligible participants, please contact us.

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