Living in Perfect Harmony

ESPP's and 401(k) Programs

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Many companies offer both 401(k) and ESPP programs. If yours does or is considering doing so, participation in one plan should really have no bearing on participation in the other; each plan offers different benefits and investment opportunities. To better understand them, let's look at the key features of an ESPP vs. 401(k) program.

ESPP

- Typically includes up to a 15% discount on purchase price
- Contribution levels changes permitted after each purchase; possibly during purchase periods.
- Participants may withdraw from purchase, but must wait until the next offering period to restart contributions
- Participants may liquidate investment at any time without penalty
- Short-term after-tax investment
- One type of investment: company stock

401(k) Plan

- Typically includes a company match
- Contribution levels may be changed on a monthly basis
- Participants may stop and restart contributions at any time
- Penalties for early liquidation of investment
- Long-term, pre-tax investment
- Select from several different investment portfolios with varying risks and rates of return

To summarize, a 401(k) is a long-term investment tool intended to help employees save for retirement. Employees invest their own money through pre-tax payroll deductions and are given a choice as to how their funds are invested, which does not include the option to invest in company stock. In some cases, the company offers a match (occasionally with conditions that the employee must remain at the company for a certain period of time before the employer match is theirs to keep) as an incentive to participate.

An ESPP, on the other hand, is a short-term investment program intended to help employees with more immediate cash flow needs/provide additional earnings that are more liquid than their 401(k) holdings. Employees also invest their own money in an ESPP program, but on a post-tax basis and participant funds are invested in company stock only so that the investment is aligned with the company's success. Further, in place of a match, most plans offer a discount.

With a good communications program, you can alleviate any issues around the notion that employees will choose one program over the other. If you are a company considering introducing an ESPP to your total rewards program, don't be mistaken; these plans do work well together. This is further evidenced in the study by Ilona Babenko of Arizona State University, which indicates that there is a positive relation between 401(k) contributions and ESPP participation rates.

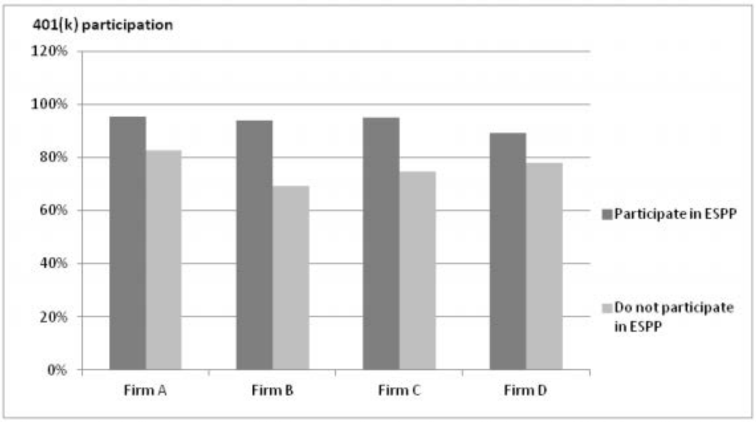

Figure 6. Relation between 401(k) participation in each firm and ESPP participation. 401(k) is equal to one for an individual if she reports to currently contribute to firm's 401(k) plan and is equal to zero otherwise.

"Finally, we explore in a univariate setting whether the employees who take advantage of riskless investment opportunity through ESPP are also more likely to participate in the general equity market and make contributions to the 401(k) plan. It can be seen from Figure 5 that indeed equity market participation rates are consistently higher among employees who sign up for the ESPP. For example, in Firm A only 10.1% of employees who ignore ESPP plan trade on the market, whereas this number is 19.0% for ESPP participants. Similarly, Figure 6 shows that there is a positive relation between 401(k) contributions and ESPP participation rates."

Choosing the best path for your company, however, depends on your unique circumstances and what the company is able to offer.