An Alternative Approach to Stock Ownership Guidelines

Stock ownership guidelines have long been the favored approach to ensure executive interests align with shareholders. These guidelines are not a statutory requirement, but an internal governance policy that sets a threshold level of company stock that an executive must retain. When public companies grant their executives equity awards through long-term incentive (LTI) programs, the expectation is that the executives will continue holding a reasonable portion of those shares even after the equity vests.

Even though most long-tenured executives hold company shares well in excess of the established ownership guidelines, investors still expect companies to maintain stock ownership policies. In fact, a recent Edelman survey asked U.S. investors to identify corporate governance practices that most impact trust in a company, and more investors selected executive stock ownership (74%[1]) than any of the other 10 corporate governance practices. Nearly all public companies maintain stock ownership guidelines, in part due to the importance investors place on these policies.

Over the years, we have observed a homogenization of stock ownership policies, with approximately 95%[2] of companies structuring the ownership guidelines as a percentage of base salary. Meridian's 2020 Corporate Governance and Incentive Design survey identifies the most common guidelines as a 6× base salary multiple for CEOs and a 3× – 4× base salary multiple for other Named Executive Officers (NEOs) at S&P 500 companies. While this approach has its merits, it is arguably flawed, especially for smaller public companies with more conservative equity-incentive grant practices. The primary benefit of this approach is that it creates a market standard (i.e., the ownership multiple), yet determines the value of the required stock ownership level using the executive's actual compensation (i.e., base salary). However, since there is not a standard compensation mix across the broad market, why tie equity ownership guidelines to cash compensation?

While using base salary to establish the required stock ownership value is simple, it can create challenges when executives have a pay mix more heavily weighted in cash compensation. This generally isn't an issue for large-cap companies, but can be overly burdensome for mid-cap and small-cap companies that establish the same market standard ownership guidelines.

Illustration of a Typical Stock Ownership Guideline

Consider a simplistic but very plausible scenario based on the following assumptions:

- **Stock Ownership Guidelines Policy:** A required threshold multiple of 3× base salary with 5 years to achieve this level. Shares owned outright, shares in qualified plans and unvested RSUs count towards the ownership level, but unexercised stock options and unearned PSUs are not included in the stock holding calculation.
- **LTI Design:** The annual LTI award consists of 50% Performance Shares (PSUs), 25% Restricted Stock Units (RSUs) and 25% stock options. The equity vehicles all cliff vest at the end of 3 years; PSUs achieve target performance.
- **LTI Grant Value:** The annual target LTI grant is 150% of base salary.
- **Tax Withholding:** 40% of full-value shares surrendered at vesting to cover tax obligations.

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[1] Edelman Trust Barometer 2020 Special Report: Institutional Investors, U.S. Results
[2] Meridian Compensation Partners, LLC 2020 Corporate Governance & Incentive Design Survey

These stock ownership guidelines are consistent with the most common market practices. However, without stock price growth, the executive will only narrowly achieve the 3× holding requirement within 5 years, even if all incentive shares are held post-vesting. For the sake of simplicity, we measured the stock ownership level in the sixth year, assuming the executive already vested in three annual LTI grants, with the remaining three annual grants in-cycle. Even after six annual LTI grants, the executive is still at risk of non-compliance with the stock ownership guidelines if the company experiences a stock price decline or PSU payouts below target.

The stock holdings that count towards the ownership guidelines are illustrated as a percentage of the annual LTI grant in the table below. This example assumes no stock price growth.

Annual LTI Grant	Award Status	PSUs (50% of Annual LTI)	RSUs (25% of Annual LTI)	Stock Options (25% of Annual LTI)
Equity Counted Towards Ownership Guideline		*Includes the Earned PSUs Only*	*Includes Vested & Unvested RSUs*	*Stock Options Not Counted in Holdings*
Year 1	Vested	30% (after-tax)	15% (after-tax)	—
Year 2	Vested	30% (after-tax)	15% (after-tax)	—
Year 3	Vested	30% (after-tax)	15% (after-tax)	—
Year 4	In-Cycle	—	25% (pre-tax)	—
Year 5	In-Cycle	—	25% (pre-tax)	—
Year 6	In-Cycle	—	25% (pre-tax)	—
Total Holdings By Vehicle		**90%**	**120%**	**—**
Total Ownership Holdings (210% of annual LTI grant)			**210% * (150% of salary) = 3.15× salary multiple**	

*Note: After-tax LTI is 60% of the pre-tax LTI (i.e., 40% tax-rate). For example, the PSU grant is 50% of the annual LTI pre-tax, but 30% of annual LTI after-tax (i.e., 50% * (1-0.4) = 30%)*

The executive's equity would be valued at 3.15× base salary in the 6th year, only slightly above the typical 3.0× guideline. The intention of most traditional stock ownership guidelines is not to force the executive to purchase shares on the open market or exercise stock options earlier than planned. Therefore, if an executive falls short of the guideline after five years, the company will likely need to either reinforce the need to get to the required levels or make a temporary exception for this individual (which most boards are loathe to do). If the executive is an NEO, the insufficient stock holdings would also be disclosed in the company's proxy statement.

Nearly all companies grant 50% or more of the target LTI value in performance awards, and many companies continue to use stock options in the LTI plan. Therefore, the example outlined above is a realistic scenario for many companies; especially those companies with a new executive. Furthermore, companies that award a lower percentage of total compensation in LTI, but establish stock ownership guidelines using the market standard, make it increasingly challenging to achieve the required ownership level in the time allotted.

The COVID-19 pandemic magnified this issue last year, especially in Q2 and Q3, when many companies experienced sharp stock price declines and forecasted little or no payouts for in-cycle PSU awards. Companies that reviewed their stock ownership guidelines last year likely saw material decreases to executive ownership levels, potentially compelling boards to rethink their ownership policies.

One potential solution is to remove the five-year time requirement from the policy and obligate executives to hold a significant portion of shares until the guidelines are achieved, regardless of the time it takes to satisfy the requirement. This approach is gaining traction as more than one-fourth of the companies (26%[3]) in Meridian's survey now structure their stock ownership policy in this manner. However, we propose an alternative approach that eliminates the need for stock ownership multiples altogether.

Stock Holding Requirements in Lieu of Ownership Guidelines

Rather than requiring executives to own a certain number of shares based on a multiple of salary, consider instead a requirement to hold a percentage of net shares for a set duration after awards vest. If the intent of ownership guidelines is to encourage or require executives to retain stock post-vesting, then a holding requirement achieves this goal.

Holding requirements have longevity, since the policy applies to every annual grant. In addition, the requirement ties directly to the number of shares granted/earned, rather than a component of compensation with little relationship to vested shares. Note that this concept is not new, though less than 5%[3] of companies use this type of holding requirement, most often in conjunction with stock ownership guidelines rather than in lieu of them.

For example, a stock holding requirement could obligate senior executives to hold 50% of all vested shares, net of tax, for three to five years post-vesting. Options would be included in this requirement as well, once exercised.

A benefit of this approach is that the value of the required holdings fluctuates based on the number of shares that vest or the number of options exercised. If an executive earns 200% of a target PSU payout, more shares must be held, whereas if only 50% of a PSU grant is earned, then the holding requirement is not as onerous. In addition, this design does not penalize executives for holding stock options. In most stock ownership guideline policies, vested stock options do not count towards the ownership guidelines, potentially putting executives in a situation where exercising options is necessary to comply with the guidelines.

If we apply this new ownership approach to the hypothetical scenario above, then the executive would be required to hold a significant portion of the total equity granted from the LTI plan. However, the executive would not be at risk of non-compliance based on the PSU payout level or stock price performance.

After six annual LTI awards, with three grants still in-cycle, the 5-year holding policy ensures the executive holds at least 87% of the total shares granted, which includes all unvested awards, unexercised options and after-tax vested shares. After 10 years, the shares held are still approximately 70% of the total shares granted over the 10 period, even though there is no longer a holding requirement on the awards granted in years 1 and 2.

[3] Meridian Compensation Partners, LLC 2020 Corporate Governance & Incentive Design Survey

10 Annual LTI Grants	Vested LTI Grant Years 1-2 *5+ Years Post-Vesting*	Vested LTI Grant Years 3-7 *50% Holding Requirement*	Unvested LTI Grant Years 8-10 *In-Cycle*	Total
Minimal Stock Holdings (as % of annual grants)	0% *No holding requirement*	238% *50% of shares after-tax, all vested options (unexercised)*	300% *All equity pre-tax*	**538%**
Total LTI Awards (as % of annual grants)	120% *All equity after-tax*	350% *Full-value shares after-tax, vested options pre-tax*	300% *All equity pre-tax*	**770%**
% of Total Shares Held	**538% ÷ 770% = 70% of total shares granted**			

Requiring an executive to hold 70% of all net shares granted over a 10-year period would certainly be considered strong alignment with shareholders. However, when viewed in the lens of the original stock ownership guideline, the required holdings after 10 years only equates to 2.8× base salary.

Given the propensity of companies to avoid being an outlier in governance and compensation practices, we are unlikely to see broad adoption of this approach in the near future. However, as more companies encounter scenarios where executives are unable to achieve the minimum holding requirements due to stock price fluctuation or PSU performance, we anticipate some movement away from strict time requirements and even traditional salary multiples, towards a simpler approach that satisfies the primary purpose of alignment with shareholders and executive "skin-in-the-game".