

AGENDA

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Comp Committees Need to Fix Broken Stock Ownership Rules

Jane T. Romweber and Annette S. Leckie are partners and advisors to compensation committees of large public companies at Meridian Compensation Partners. They consult on pay levels, program design, pay-for-performance linkage, governance best practices, institutional shareholder issues, employment contracts, severance, retention and change-in-control arrangements.

Stock ownership guidelines for senior executives have become nearly ubiquitous at large public companies in the U.S., and for good reason. Ensuring that executives own sufficient amounts of company stock for the long term aligns their financial interests with shareholders'.

Yet even when executives meet such requirements, guidelines can fail to create appropriate levels of true ownership. The reason: The typical guideline design is too uniform to be effective for companies with widely varying levels of equity grants.

Accordingly, to ensure that their guidelines reflect true ownership, compensation committees should critically assess key components of the standard guideline design against their companies' long-term incentive programs. The aspects that they need to consider closely include:

Basing ownership levels on a multiple of salary. Most guidelines call for the CEO to own stock valued at five times his or her base salary. This may be too low a bar at companies that annually provide the CEO the opportunity to earn equity of that value or more, and too high a bar at companies that grant considerably smaller amounts of equity relative to salary.

Using multiples of salary can also be problematic for lower-level executives. Multiples that are too high versus executives' typical grant sizes may force them to buy stock to meet guidelines, while the CEO would not have to do so. This scenario can lower morale, and raises the question of how far down the corporate ladder ownership guidelines should apply.

Counting stock granted as stock owned. The standard guideline design counts unvested, time-based restricted stock toward required ownership levels. Yet such shares have not been fully earned or taxed, so they fall short of true ownership.

In addition, counting them makes meeting guidelines far easier at companies that grant substantial amounts of restricted stock than at companies granting more equity based on performance. This inappropriately allows executives who receive relatively more time-based restricted stock to meet guidelines more easily, and with less risk, than those who receive more performance-based compensation.

Accumulation periods. Most guidelines call for executives to accumulate the required level of equity within a five-year period. Yet if the share price plunges, as it did for many companies in 2008 and 2009, many executives would suddenly fall out of compliance. As a result, they might have to purchase significant amounts of stock just when their existing holdings have declined in value.

Compensation committees might instead consider basing ownership levels on the average value of recent long-term equity incentive grants relative to salary, using a multiple between 1.5 and two. Applying this range of multiples, an executive whose average award had equaled six times salary would have an ownership guideline of nine to 12 times salary. This relationship should be reassessed when reviewing guidelines periodically.

Lower-risk incentives, such as time-based restricted stock, would lead to a higher multiple or be excluded from the calculation of stock owned.

Finally, accumulation periods can be eliminated in favor of requiring that executives hold 50% to 100% of all after-tax equity received through incentive programs until the guideline is met. As long as executives comply with holding requirements, they will be compliant with ownership guidelines. This approach has been gaining favor in recent years.

By considering these factors, compensation committees can craft guidelines that result in appropriate levels of true ownership. In so doing, they can ensure that executives' interests — and their exposure to risk — are aligned with those of shareholders for the long term.