Post #62: Stock Ownership Guidelines in Challenging Times

From Chris Havey, Partner, The Woodlands, TX

Stock ownership guidelines are nearly universal for both executives and directors. They help ensure alignment with shareholders by encouraging executives and outside directors to hold onto a substantial amount of company stock. They have historically not required a substantial open-market purchase of company stock. Rather, both executives and directors can typically meet their required guidelines through holding normal annual equity grants.

Recent stock price declines across the oil & gas industry have likely created challenges for executives and outside directors to maintain the required level of ownership. There are a number of temporary solutions that companies can adopt to address the current unprecedented environment. This may also be a good time to reconsider the design of stock ownership requirements to improve how they work regardless of stock price volatility.

Potential Temporary Solutions

These potential solutions can address the unprecedented nature of this current environment, with stock prices at many companies down 50% or more this year. Many of these solutions use an alternative price to measure the value of current ownership. A few examples include:

- Use a 12 month or other long term average stock price to measure compliance—using a longer term average stock price mitigates the impact of short-term volatility; however, an extended downturn may cause executives and directors to still fall out of compliance with stock ownership requirements.
- Use the greater of 1) the current price or 2) the price at acquisition (or vesting) to measure compliance—philosophically, we think a lot of companies would like this approach, but it can be complicated to administer because it requires tracking the acquisition prices for all shares owned.
- Add a grace period of 2-3 years, if a participant has not otherwise sold shares, to allow time for regular awards to refresh total ownership—this could apply for salary increases (and resulting increases in required ownership) or stock price declines.
- Temporarily suspend the guidelines—this is a simple approach, but could be perceived negatively by shareholders as de-emphasizing the importance of shareholder alignment.

A Better Approach

The current market volatility might lead companies to desire a better approach that would be more sustainable in both up and down markets while also strengthening the alignment with shareholders. A potential approach could include the following two elements:

- A Holding Requirement—The individual must retain a fixed percentage of all shares granted (net of taxes, net of exercise price for options); this percentage could be 100%, but a lower amount (e.g., 75%) might also work.

- A Required Ownership Level—The individual cannot sell any shares beyond the holding requirement unless that individual's ownership levels, based on current stock prices, exceed the required ownership level following any desired sale.

The "required ownership levels" might be similar to current stock ownership guidelines (e.g., 5-6x salary for CEO, 2-3x salary for other officers). However, a higher level may be appropriate as these are no longer "requirements", but instead provide an opportunity to sell. Additionally, the current prevailing standards for ownership guidelines can generally be hit with 1-2 years of LTI grants, absent a significant stock price decline. So a more stringent standard may be appropriate (e.g., 10x salary for a CEO?) and send a signal about the importance of shareholder alignment.

This alternative approach is flexible enough to accommodate the current environment, because an individual would still be in "compliance" as long as they aren't selling shares.

Get Ready for Disclosures

Assuming stock prices remain at a reduced level during the remainder of 2020, we imagine that many oil & gas companies will evaluate their current guidelines and the potential required disclosures in next year's proxy. While many will choose one of the temporary solutions above, it may be worthwhile to consider whether a more flexible longer term solution makes better sense.