Stock Ownership Guideline Administration

- JOHN R. SINKULAR AND DON KOKOSKIE

This Viewpoint is one in a series of ongoing articles Pay Governance will be publishing regarding the impact of COVID-19 on compensation programs. All of our Viewpoints can be found on our website at www.paygovernance.com.

The financial impact of the current pandemic has affected most aspects of the compensation programs for executives and nonemployee members of the Board of Directors. Stock ownership requirements covering those individuals are no exception and will be reviewed by companies as they assess compliance with those guidelines.

Stock ownership guidelines are a near universal practice at larger publicly traded companies and are considered a governance best practice. Ownership guidelines require executives and directors to maintain meaningful stock ownership during their tenure. Officers have significant additional investments in the company — usually through several years of outstanding, unvested equity awards. In the case of performance shares, the award opportunity is leveraged to both achieve specified goals and stock price movement. This Viewpoint focuses on those elements of ownership guidelines often subject to greater volatility in company stock price and performance.

A common structure requires executives to achieve a specified ownership level within a five-year period. However, most companies now grant at least 50% of their target long-term incentive (LTI) opportunities as performance-contingent awards (e.g., performance shares) based on achieving financial and/or total shareholder return goals, often over a three-year period. With the current crisis potentially eliminating the opportunity to earn shares from one, two, or all three outstanding performance cycles, meeting the guidelines within a five-year timeline could be difficult. Increased stock price volatility brought about by the pandemic may

KEY TAKEAWAYS

- Stock ownership guidelines are a common element of today's pay programs for executives and directors which reinforce one of the key objectives of equity awards: building and maintaining stock ownership over an individual's career.
- Compliance with those guidelines can be problematic in times when there is considerable volatility in financial results and stock prices as most companies are currently experiencing.
- Companies may want to examine the structure and administrative practices associated with their guidelines to ensure they align with the spirit and intent behind them.
- Some companies already have guideline provisions that mitigate stock price volatility (e.g., using an average stock price to assess ownership compliance) and recognize the highest long-term incentive weighting is typically on performance shares (e.g., not fixed time for compliance).
- Ownership guideline designs and administrative provisions can and should vary by company, recognizing there is no universal approach mandated by the Securities and Exchange Commission or the stock exchanges.

exacerbate the situation, resulting in individuals shifting between compliance and non-compliance solely due to swings in stock price.

As a result, this may be an opportune time for companies to review the governance and administrative polices of their stock ownership guidelines to ensure they align with the company's objectives and will not require numerous exceptions during periods of heightened economic and stock price volatility. Since stock prices decrease and increase, it is important to have policies that are durable in both down and up markets. For companies experiencing sustained and significant stock price declines (a decrease of 50% or more), instead of pursuing design changes some may decide to suspend updating the assessment (e.g., use the results of the prior year's compliance review and consider the ownership guideline maintained or, for those building to compliance, "on track" as long as the individual's number of shares considered owned did not decrease) until the stock price recovers.

The table below examines stock ownership guideline design provisions that mitigate stock price volatility and recognize that most companies emphasize performance-contingent awards in their regular LTI grants.

Provision	Common Practice	Alternative(s) to Consider	Rationale
Time Period for Compliance	• Five years from starting in a position subject to ownership requirements or joining the Board	• No specified minimum compliance period • Require executives and directors to retain 50% to 100% of after-tax shares until guidelines are met (i.e., retention/holding requirement)	• Recognizes potential variability in earning performance shares and stock price volatility over time • Companies still may expect that guidelines will be achieved within five years
Stock Price to Assess Compliance	• Price at date of annual assessment, or • Recent average closing price (e.g., 10, 20, or 30 days)	• Monthly or quarterly average price • Average price for the year • Multi-year average stock price • Higher of current price or trailing 36 month average closing prices • Average of prices used for annual LTI awards	• Minimizes volatility between measurements, recognizing the intent of stock ownership is to be achieved and maintained over an individual's career
Impact of Stock Price Decline After Compliance Is Achieved	• Executives and Board directors must increase the shares owned to maintain compliance for next year's assessment	• Consider "once in-compliance, always in compliance" as long as the number of shares that achieved compliance is maintained	• Converts guideline (normally as a multiple of salary) to a minimum fixed number of shares • After achieving compliance, eliminates falling out of compliance solely due to a stock price decrease
Impact of Nearing Retirement	• None: ownership requirements apply through an officer/director's career	• As company stock is one of an executive's largest assets, allow the executive to diversify as they near age 65 (e.g., reduce guideline by 10% per year for up to a 50% reduction)	• Allows officers to diversify their stock ownership as they near retirement age

Thoughtfully designed officer and director stock ownership guidelines are an important part of a well-designed executive pay program. Guidelines should balance reasonable stock accumulation and retention of shares over time, external stakeholder perspectives, and desires for individuals to plan for financial needs in retirement. In the end, stock ownership guidelines are just that: guidelines. There are no "generally acceptable stock ownership principles" that must be met. However, proxy advisors and many institutional investors have well-established perspectives on executive and director stock ownership guidelines. As a result, companies should ensure their stock ownership guidelines and administration practices best align to their objectives, culture, officer demographics, and other factors they deem important.

General questions about this Viewpoint can be directed to John R. Sinkular at john.sinkular@paygovernance.com or Don Kokoskie at don.kokoskie@paygovernance.com.