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Too Much Employer Stock? Don't Ignore Diversification

By **Mark Poerio** (July 12, 2018, 2:07 PM EDT)

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From Forbes to the New York Times to the U.S. Securities and Exchange Commission, there have been recent thought-provoking commentaries (noted below) about the risks and potential abuses that may arise when executives own or have stock awards that make them feel overly invested in their employer’s stock. Nevertheless, board members and compensation committees may turn a deaf ear. That is understandable because diversification programs seem generally contrary to a core goal of executive compensation, namely: aligning executive interests with those of shareholders. Sometimes, however, the pendulum swings too far, with diversification being sensible in situations such as those discussed below.

Stock Awards Settled on Termination of Employment

There are often good reasons to defer the settlement of stock awards until on, or after, an executive’s termination of employment. For instance, the awards granting restricted stock or units, also known as RSUs, usually provide for the issuance of unrestricted shares when vesting occurs. That is not required, however, and awards may instead provide that vested shares will be “held back” as deferred compensation.

The future issuance of unrestricted shares may occur at a time that the employer hardwires into an award, such as termination of employment or an earlier change in control. Awards may instead allow individual elections by executives, from among various distribution alternatives that are permissible under Internal Revenue Code section 409A regulations. Regardless of the construct, a holdback of shares may be designed so that executives have an escalating stake in employer stock. Further, the holdback may be coupled with forfeiture and/or clawback features that encourage executives to honor covenants relating to protection of their employer’s trade secrets, as well as to honor post-employment covenants such as noncompetition and nonsolicitation restrictions.

There is a downside to what are commonly called “hold through retirement” provisions.[1] Absent a diversification program, an executive may need to resign in order to convert restricted stock units or stock-based deferred compensation into a different investment. Solutions are available and are straightforward to implement mainly because IRC Section 409A regulations permit diversification without the need for a termination of employment. This is possible through prospectively changing the measure for future investment return. However, nothing should be done without first considering applicable tax and accounting implications, and how shareholders and stock analysts will react to the change.

Overexposure to Employer Stock Could Warp Executive Decisions

The warnings have come in 2018 from the New York Times ("**You've Got Lots of Company Stock. Now What?**") and Forbes ("**Equity Compensation is Great. But Is It Leaving Your Investments Overexposed?**"). For executives who feel over-invested in employer stock, there are two natural responses, namely: (1) pursue a less risky business strategy in order to protect against loss, or (2) pursue an exit strategy such as a company sale in order to maximize or lock in value. Termination of employment is, of course, another exit strategy. Note that executives are normally foreclosed from hedging their employer stock investments, both because that is a widely criticized practice and because public companies which allow hedging would have to disclose that publicly (pursuant to Section 955 of the Dodd-Frank Act and associated SEC rules).

For a company that desires sustained long-term growth, it may make sense to allow executives to diversify their risk through a well-informed strategy that enables them to sell shares during company-authorized trading windows. These are normally established through insider trading policies. Another vehicle for diversification comes in the form of a 10b5-1 plan. Public companies may authorize plans of this kind in order to permit select executives to lock in a future schedule for the sale of predetermined numbers of shares on dates and at prices that are also predetermined. When sales occur pursuant to 10b5-1 plans, there is a presumption that insider trading violations have not occurred, and this obviates the need to restrict trade dates to window periods following the release of company financial statements.

Employer Stock Is Not a Magic Elixir

It is unquestionably a best practice to encourage executives to own employer stock, and to make stock awards to them, in order to align the financial interests of executives with those of shareholders. Recent survey data indicates that six times base salary is a common target that many public companies have established through stock ownership guidelines.[2]

Too much employer stock may however create winners and losers due not to executive merit but instead due to the vagaries of the stock market or of particular industries. In order to avoid this, employers and their compensation committees should consider balancing stock awards with long-term deferred compensation that is awarded pursuant to what is known in the U.S. as a nonqualified plan (because “qualified plans” defer compensation for retirement on tax-favored terms).

Under a nonqualified plan, both the amount credited to an executive’s account and the future rate of return on that account may be determined by reference to a corporate performance measure, but without reference to the value of employer stock. For example, corporate and/or divisional performance measures — such as earnings — may determine how much an employer credits to the deferred compensation accounts of eligible executives. Those credits could also occur based on subjective measures, which are usually tied to individual performance, such as management by objectives. The same or different measures may determine the future rate of return on deferred compensation accounts.

As the foregoing indicates, there are many possibilities for designing deferred compensation in a manner that soundly complements stock awards that executives would otherwise receive. As noted above, deferred compensation may be structured to serve as an incentive to encourage executives to protect their employer’s trade secrets as well as to honor their post-employment covenants, such as noncompetes. It takes some thought. But the exercise could be a win-win for companies and executives.

Conclusion

In widely reported remarks,[3] SEC Commissioner Robert Jackson recently called on corporate boards and their counsel to focus on how stock buybacks affect long-term corporate performance and the link between pay and performance. He advised, "Corporate boards and executives should be working on [creating long-term sustainable value], not cashing in on short-term financial engineering."

Diversification programs involving employer stock can serve valid, long-term corporate purposes if properly designed. This may seem like a formidable challenge, but executive compensation has become a high stakes corporate exercise that promises to reward those who are smart and forward-looking.

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[1] Detailed information about hold through retirement provisions appears on this webpage within CompensationStandards.com.

[2] See https://www.executiveloyalty.org/stock-ownership-guidelines.html for data that ClearBridge Compensation Group published in 2018.

[3] www.sec.gov/news/speech/speech-jackson-061118