Meet Stock Ownership Guidelines with Nonqualified Deferred Comp Plans

By using stock ownership to tie senior management to your organization, effectively you drive behavioral performance and change. Without it, you get status quo—it is human nature.

No one washes a rented car.

This saying encapsulates an important idea. Little incentive exists to wash or maintain a car that one does not own. For example, the renter does not benefit from the resale of the rental car nor the income generated by leasing it. In fact, the renter may never see the car again.

However, a person who owns something experiences a strong incentive to take care of it.

Public companies are beholden to align long-term interests of executive officers with those of their shareholders. Typically, they attempt to meet that obligation by aligning their pay in relation to company performance.

Many companies address this issue using equity packages. However, because executives can still sell or hedge these shares, their incentive to make decisions in long-term corporate interest tend to blur.

To avoid this dilemma, some companies implement stock ownership guidelines, which require executives and, in some cases, directors, to own a certain amount of equity in the company.

Ownership guidelines instruct executives to obtain a certain amount of shares within a set timeframe; holding requirements mandate they retain a certain amount of shares received through vesting of stock or exercising of options.

Aside from incentivizing executives, it is important to implement one or both policies for shareholder support, as well as for proxy advisors to justify pay packages.

Equilar, a leading provider of board intelligence solutions, examined various trends and components of executive stock ownership over 2012, 2013 and 2014 fiscal years for Fortune 100 companies. The firm found that a combination of ownership guidelines and holding requirements increased considerably during that time frame.

Also, a steady increase in the value of required stock ownership has increased over the past three years. Overall, Fortune 100 companies are implementing more restrictive stock ownership requirements with a higher median target value of required equity.

EBS sees these guidelines extended even into mid-market companies as a device to align the interest of executives with shareholders.

Participation in Ownership Guidelines

Generally, participation is limited to senior executives and outside company directors. Nearly all companies with ownership guidelines include the CEO and the direct reports (EVPs and SVPs). Some companies extend guidelines to one additional level (typically, the VP level). Few companies establish an ownership guideline below VP level, preferring to scale the requirement to upper executive levels.

Ownership Requirement

In defining the ownership requirement, companies use either a multiple of salary/retainer or a fixed number of shares. Most companies will require that a specified value of stock, expressed as a multiple of salary (or retainer for directors) be held by each participating executive.

Given that share price can fluctuate over time, changing the value of the shares held, many companies will use an average share price (90 days or 180 days) to calculate the value of shares held. A common framework for executive ownership requirement resembles the following:

Level	Requirement
CEO	**Five times salary**
Executive/Senior Vice President	**Three times salary**
Vice President	**One times salary**

(Typical outside director requirements range between two to three times retainer.)

Institutional Shareholder Services considers a five times requirement “adequate” for a CEO; however, a six times or greater multiple is “preferred” and will generate a better QuickScore under its methodology.

While most companies use a multiple of salary to define the ownership requirement, some companies use a fixed number of shares to define the ownership requirement. Using a fixed number of shares eliminates the impact of share price volatility; however, an extended decline in the share price of the company could leave executives holding a much smaller stake in the company than desired.

Outright Ownership

Universally, outright ownership of company stock is deemed to be ownership under stock ownership guidelines. Most companies expand the ownership definition also to include shares held in retirement accounts, nonqualified deferred compensation (NQDC) arrangements, and unvested restricted shares, RSUs and deferred shares. A small minority of companies allow for counting other forms of equity toward ownership, such as vested stock options or unpaid performance shares.

Company Programs Meet Guidelines

With a large portion of an executive’s pay package coming from equity-based programs, the company applies the shares toward guidelines through various programs. However, because of taxation on stock options, restricted stock and restricted stock units, in many cases, the executive ends up with fewer shares to apply.

As an example, if the company issues an executive 20,000 shares of restricted stock units (RSUs) or restricted shares at $50 per share with a three-year vesting schedule, he or she must report the tax when they vest. So, in year one, they include one-third of the value, $333,333 in income. Because of the tax bite, many executives are forced to sell a portion of the shares to pay taxes. In this case, at a 40 percent tax rate, the executive ends up with 4,000 shares versus the 6,666 that vested.

The remaining shares will be taxed in year two and three, based on the market value of the shares. So, if the $50 per share increases to $60 or $70, the executive will report income on the increased amounts and be forced to go out of pocket with cash to pay the taxes or sell shares, as we explained in year one.

The same issues apply to the exercise of stock options.

Defer the RSUs

Deferral is one way to maximize the benefits of RSUs and apply them toward the stock ownership guidelines. Many companies allow their executives the opportunity to defer the units, rather than face taxes when the RSUs vest.

In this scenario, the executive defers paying tax on the taxable compensation until he or she receives a distribution from the deferred compensation plan. This way, they are not forced to sell shares. Instead, they receive the benefit of 100 percent growth of the RSUs granted, compared only to the residual amount after the sale of shares to pay taxes upon vesting.

Further, if the company credits dividend equivalents to the RSUs deferred, the executive receives such dividend equivalents on 100 percent of the RSUs. Again, this receipt is preferable to only the net amount of shares remaining after sales to pay taxes upon vesting.

To take advantage of this deferral feature, the executive must hold the shares (units) in the deferred compensation plan, and the company must pay the executive with shares at distribution.

You may find details of this deferral feature in our white paper entitled, *Restricted Stock Units in a Nonqualified Deferred Compensation Plan – An Effective Tax Planning Tool for Future Financial Needs,* downloadable here.

By using the deferral feature, the executive receives credit in the proxy for shares owned and may elect to spread out the distribution and be taxed, accordingly.

Notwithstanding the benefits of credit for stock ownership and tax deferral, many executives are reluctant to defer RSUs, and other forms of stock compensation, due to the restrictions on distribution under IRS §409A.

If our executives deferred the RSUs at $50 per share, they would not be permitted to sell those shares while in the deferred compensation plan, until their elected distribution. Consequently, they may encounter market volatility.

Two Ways to Mitigate Volatility Risk

Enter a new risk management tool called the **Stock Protection Fund;** it is affordable, tax-efficient, simple to use, easy to understand, and can protect the downside of an executive's deferred shares. Please visit StockShield for the interesting details.

Because the Stock Protection Fund is not a hedging strategy, it applies to most company policies against hedging; it is simply a risk management tool.

The second mitigation solution allows diversification once guidelines have been met. Now used by many companies, this solution acts as an incentive to meet stock ownership guidelines. If the executive elects to defer the taxation of the RSUs—once he has enough shares to meet the guidelines—he could (subject to certain conditions) diversify additional shares in the deferred compensation account across a wide range of notional investment funds.

And, the notional fund line-up could include a "collared index" option to allow allocation to the equity markets, with downside protection, quite an attractive feature given today's stock market volatility.

Similar to the executive's 401(k) plan or nonqualified deferred compensation plan, he gains 24/7 access to reallocate within the tax-deferred plan, as well as the freedom to select when to take distributions.

Critical Piece: The Accounting

For the company, proper accounting treatment leads to desirable outcomes. EBS has mastered this critical treatment by carefully establishing and vetting it with seasoned accounting and tax firms.

If you wish to minimize taxes and diversify investment risk, please sit down with an EBS consultant to work through the optimal structure for you.

We invite you to a no-obligation, educational conversation at your earliest convenience.

In the meantime, for added information on the exceptional concept of using your NQDC plan to meet stock ownership guidelines, click the link.

ABOUT EXECUTIVE BENEFIT SOLUTIONS, LLC

EBS is an independent executive benefits consulting firm which provides total plan management services with respect to programs specifically designed for key employees and professionals. Those services include:

- Consulting with respect to plan design,
- The structuring of related financing and benefit security arrangements,
- The design and management of the participant communication, education and enrollment processes,
- Management of any informal funding assets and,
- On-going plan administration and technical support.

More information about the firm can be found at: www.executivebenefitsolutions.com.

CONTACT INFORMATION:

EBS-Boston
20 Park Plaza, Suite 1116
Boston MA 02116
Phone: **617.904.9444**
Fax: 866.903.9927

Christopher Rich
Managing Director
crich@ebs-boston.com

Chris Wyrtzen
Managing Director
cwyrtzen@ebs-boston.com

Robert Flood
Managing Director
rflood@ebs-boston.com

National Administration
801 E. Plano Parkway,
Suite 216
Plano, TX 75704
972.422.8298

Bonnie Barnes
Vice President of Plan Administration
bbarnes@ebs-boston.com

EBS-West
1902 Wright Place, Suite 200
Carlsbad, CA 92008
760.788.1321

William L. MacDonald
Managing Director
858.759.8637
wmacdonald@ebs-west.com

Don Curristan
Managing Director
760.788.1321
dcurristan@ebs-west.com

Trevor K. Lattin
Managing Director
949.306.5617
tlattin@ebs-west.com

EBS-Milwaukee
601 Genesee Street
Delafield, WI 53018
262.853.7755

Robert Birdsell
Managing Director
bob.birdsell@ebs-milwaukee.com

EBS-Richmond
3801-A Westerre Parkway
Richmond, VA 23233
804.317.9670

Hugh Carter
Managing Director
hcarter@ebs-richmond.com