Creating a C-Suite Culture of Long-Term Ownership:

How to Make Equity Packages Abundant and Air Tight

An Educational White Paper
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EBS Executive Benefit Solutions

CEOs, board members, and shareholders share an unpleasant mental habit.

They *worry* about how to best manage their companies against threats as ominous as terrorist attacks and cybersecurity to on-going needs of finding capital and new talent. And do it all at a profit.

Scarcity of talent ranks high on their worry list in study after study. Mercer reports 43 percent of business executives see a significant increase in competition for executive talent. With a tight labor market, retiring baby boomers, and the next generation of executives in development, solutions are needed now.

One CEO told *Business News Daily*: *"There's been a shift in mindset and companies are placing a higher importance on finding employees whose visions and values are in line with the company's as opposed to finding employees with a laundry list of accolades."*

Add to this vacuum executive turnover. How do you hold onto your star performers and transform average achievers to higher performers?

Losing top talent is massively expensive. A recent *Forbes* article cautioned that since 2011, U.S. employee turnover rates have continued to climb, with approximately nine to 20 percent of employees lost in annual turnover, depending on the industry. The cost to companies ranges from 16 to 213 percent of annual salary.

You may recall McKinsey and Company coined the term "War for Talent" more than twenty years ago. Its assertions remain valid today. Only in a far more complicated climate than ever dreamt by McKinsey visionaries.

Another trend emerged twenty years ago to cope with the challenge of attracting and retaining executive talent: **stock ownership guidelines and retention policies.**

We intend for this white paper to reaffirm the importance of **stock ownership guidelines** to encourage and build stock ownership by C-suite executives. Owning company stock links the financial interests of executives to shareholders and elevates corporate performance.

Certainly, this is not a recent innovation. Of Fortune 500 companies, 92 percent put into place either ownership guidelines or holding requirements or both decades ago. Historically, this move helped set these companies apart from the competition. However, because this once-differentiated move is now common, Towers Watson declares in its *Executive Compensation Bulletin* that, ***"increasingly, companies are revising their ownership guidelines to once again set themselves apart from the pack."***

EBS managing directors see these guidelines now extending to mid-market companies as a reliable device to merge the interest of executives with corporate shareholders.

Further to our intention for this paper, we lay out strategies for you to:
1) help executives meet stock ownership guidelines with pre-tax dollars;
2) defer restricted stock and restricted stock units (RSUs);
3) reward executives with deferral and diversification of RSUs; and, best of all,
4) minimize any concentrated stock risk with an effective new protection strategy

Let's get started.

And we promise, even though stock guidelines may not be a compelling topic, we'll make it a fast and interesting read. After all, what's more interesting than accumulating wealth for your retirement?

In the last two years, states the Towers Watson study, 30 percent of major U.S. companies began entering the next generation of ownership guidelines with these actions:

- increase C-level executives' ownership requirements
- implement stock retention policies for those unable to meet ownership requirements
- institute penalties and incentives to achieve guideline compliance

By reducing a tendency for executives to hedge or sell shares after the vesting period, companies seek to inspire executives to perform in the mindset of a long-term owner.

Before we discuss how companies can help their executives meet stock ownership guidelines more readily, let's revisit the basics of stock ownership guidelines and holding requirements for those who may not be familiar with the practice.

Skin in the Game

Aptly coined by legendary investor Warren Buffett, "skin in the game" refers to high-ranking insiders using their own money to buy stock in the company they run. Of course, you knew that.

Buffet understood corporations must be managed by like-minded individuals who share a stake in the company. As Investopedia opines, *"executives can talk all they want, but the best vote of confidence is putting one's own money on the line just like outside investors."*

Equity Considerations

Under stock ownership guidelines, shares owned outright, acquired in the market or through grants and awards, count toward ownership guideline requirements. Most companies expand ownership also to mean shares held in:

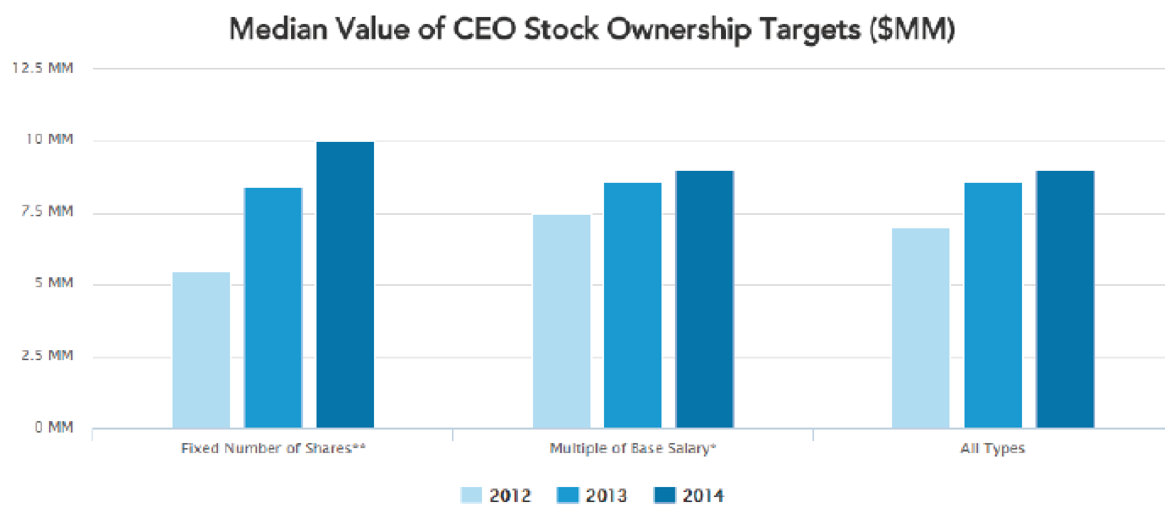
- Retirement accounts
- Nonqualified deferred compensation (NQDC) arrangements
- 401(k), ESOP and ESPP shares
- Stock options
- Unvested restricted shares, restricted stock units (RSUs) and deferred shares
- Vested stock options or unpaid performance shares
- Shares held by immediate family members and family trusts

Some companies create equity packages with a combination of the above.

The Basics: Ownership Guidelines and Retention Policies

Ownership guidelines direct 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. One or both policies should be implemented to satisfy greater expectations of shareholders, and for proxy advisors to justify pay packages.

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



* Assumes base salary from fiscal year represented in chart.

** Assumes year-end stock price for fiscal year per section.

Source: Equilar

As you see above**,** major companies are implementing more restrictive stock ownership requirements with a higher median target value of required equity, based on research of the Fortune 100 by Equilar, a leader in board intelligence. Notice how ownership targets rose from $7 million to $9 million. Fixed share requirements nearly doubled from $5.5 million to $10 million due, in part, to increasing stock prices, in Equilar's estimation.

Many companies use an average share price (90 days or 180 days) to calculate the value of shares held due to stock price fluctuation. 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**

[Note: 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 it, which eliminates the impact of share price volatility. However, an extended decline in company share price can leave executives holding a much smaller stake in the company than desired.

It bears repeating, this whole process ostensibly serves as a competitive tool in the battle for talent and a retention net to hold onto that talent. Where it promises the greatest results lies in its role as a **mechanism to influence behavior and push a cultural attitude of long-term ownership and sustainable performance.**

Who Participates?

In general, companies limit participation to senior executives and outside company directors. Nearly all companies with ownership guidelines include the CEO and direct reports from senior vice presidents to executive vice presidents.

Some companies extend their guidelines to the vice president level. Few companies establish an ownership guideline below VP level, preferring to scale the requirement to upper executive levels with the potential to make a significant difference in corporate outcomes. However, Towers Watson indicates that sometimes guidelines *"can be broad enough to cover hundreds of employees."*

For How Long?

A quick word about holding requirements, also called retention policies. Executives are allowed a set number of years to accumulate the specified ownership level. Based on Tower Watson data, 54 percent of all companies studied give participants five years to meet ownership guidelines. However, time periods can range from one to eight years. Typically, companies establish annual progress requirements or gradual application of the guidelines unless a specified retention policy is in place.

Meeting Ownership Guidelines

While companies do attempt to help executives meet guidelines, and it is in their interest to do so, is it sufficient to instill ownership thinking and inspired performance? The answer is no.

Instead, if you reward an executive with stock, allow him to defer tax liability to grow his equity, then reduce risk by permitting him to diversify and, on top of that, secure his holdings with a stock protection fund, his thinking will change—from short-term employee to long-term owner. *In the next few pages, we will show you how to accomplish the ultimate package of skin-in-the-game incentives.*

Repackage Equity for Maximum Value

A large portion of executive compensation packages comprises equity-based programs, used by companies to apply shares toward meeting guidelines. Restricted stock and RSUs account for 89 percent executive’s pay package and 85 percent of middle management in publicly traded companies issuing these grants.

Restricted stock and RSUs differ in that RSUs represent a measurement of contractual rights to a company's stock. Often, the measurement is 1:1, meaning that each unit exchanges for one share of stock upon the "settlement" of the units.

With RSUs, the number of units earned by the executive vests like the common provisions of restricted stock. Executives can earn units under the vesting conditions of the agreement and are contractually entitled to exchange the units for stock or cash or some combination of the two depending upon the terms of the agreement.

Restricted stock is a grant of stock that holds certain vesting conditions, usually related to the passage of time and continued employment. The holder has legal title to the stock, subject to the company's contractual right to repurchase if the vesting conditions are not met, as in the case of an employee or founder termination or departure from the company.

However, executives can easily end up with fewer shares to apply to meet their stock ownership guidelines, undermining the ownership mindset, due to taxes on restricted stock and RSUs, which is why we want you to improve their value and revise guidelines.

By example, if the company issues an executive 20,000 shares of 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. **Many executives are forced to sell a portion of the shares to pay taxes**. 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. If the $50 per share increases to $60 or $70, and the executive reports income on the increased amounts, he or she goes cash out of pocket to pay the taxes or sell shares, as explained in year one. The identical issue applies to the exercise of stock options.

Failure to Meet Guidelines

Companies may impose penalties in the event of an executive's failure to meet stock ownership guidelines including:

- Require retention of all or a portion of net shares post exercise or settlement
- Pay performance or annual bonus in stock
- Reduce aggregate compensation
- Disclose Named Executive Officers
- Build peer pressure and an "embarrassment factor"
- Reduce or eliminate future equity or incentive awards.

Why force executives through this potential gauntlet of penalties?

The good news is 63 percent of companies do not penalize executives for failing to achieve guidelines, claims Stock & Option Solutions' research.

Instead, open the corporate helping hand a bit wider. Three strategies exist that you may not know about or may not know how to implement. To take advantage of these accelerators to meeting guidelines, you need to consider adding features and revising your stock ownership guidelines.

Time to Revise Ownership Guidelines

We encourage your compensation committee to investigate three well-developed approaches to making equity packages more abundant for executives and more air tight for shareholders.

First, add the feature which enables executives to defer restricted stock units into NQDCs. Second, reward executives with the ability to diversify those RSUs. Third, protect their holdings with the smartest risk management tool on the market. Let's get into some details.

Defer Your RSUs

Deferral maximizes the benefits of RSUs, particularly when you apply them toward the stock ownership guidelines. Many companies allow their executives the opportunity to defer units, rather than face taxes when the RSUs vest.

By deferring, executives can elect to spread out the distribution and be taxed, accordingly. Let's say the executive vests in the first four years; he's not paying income taxes. Therefore, at the end of four years, he holds the 4,000 shares with a value of $193,600 ($33 per share). If he takes a distribution in two years following vesting, the value, based on a hypothetical projection, is worth $200,000 ($50 per share).

Pay Tax when Vested and Sell		Defer Shares
$120,000 (1)	Value of Shares at Distribution	$ 200,000
43,200 (1)	Ordinary Income Tax Paid	80,000
2,400	Capital Gains Tax Paid	0
$117,600	Net Cash to Executive	$ 120,000

(1) Assumes ordinary income tax @ 40% and capital gains at 20%
(1) Assumes executive sold 400 shares each year to pay tax, therefore, at the sale, he was holding 2,400 net shares.

In this scenario, the executive defers paying tax on the value of the restricted stock 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.

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.

Although executives benefit from credit for stock ownership and tax deferral, many 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 NQDC plan, until their elected distribution. As a result, they do face market volatility. However, we offer two solutions to level out the inevitability of some stock volatility over time, later in this paper.

The real benefit is spreading the payments over a period of time. In fact, if we spread the payments over ten years or longer, and take up residency in a state with a lower or no income tax, we can avoid paying state income tax in the state where we received the RSUs.

As an example, an executive living in California who retires and resides in Nevada, Texas, Florida, Tennessee, New Hampshire, Washington, Wyoming or South Dakota can save up to 13 percent in state income taxes.

Historically, executives' concern rests with the investment risk of holding a single company stock for a long period. Most financial planners would recommend diversification. However, most corporations interpreted the accounting rules to require mark-to-market treatment of RSUs if diversification were permitted. EBS has worked to clients to develop a methodology that substantially mitigates this issue, and only requires mark-to-market accounting on those RSUs that are actually diversified, not all RSUs deferred under the plan.

We invite you to download deeper detail in our specialty brochure entitled, Restricted Stock Units in a Nonqualified Deferred Compensation Plan—An Effective Tax Planning Tool for Future Financial Needs.

With shares deferred into your NQDC, you want to diversify as the next effective strategy to meet your ownership guidelines, assuming company willingness to revise the plan.

Diversify Your RSUs

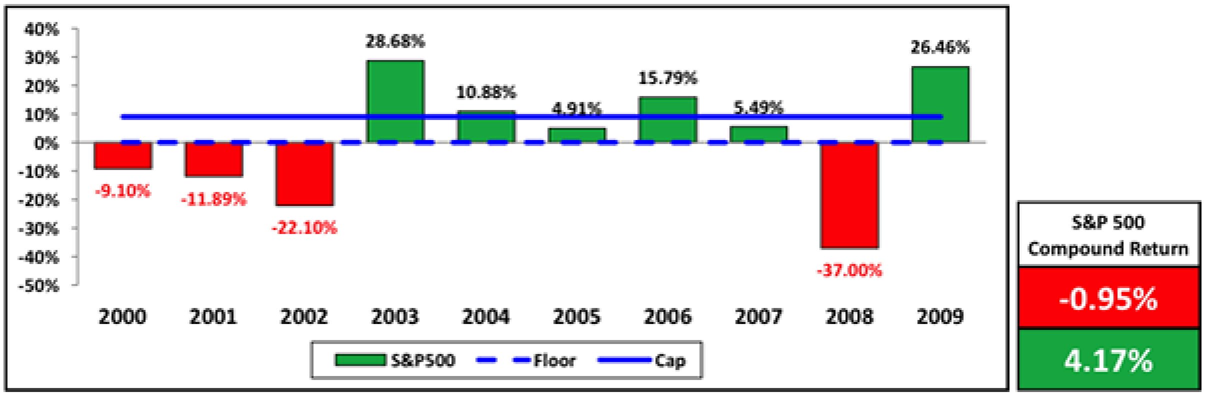
The second revision recommendation worth consideration allows diversification of RSUs once stock ownership guidelines are met. Now used by many companies, this solution further incentivizes executives to meet stock ownership guidelines.

If the executive elects to defer tax on the RSUs—once he holds sufficient shares to meet the guidelines—he could diversify additional shares in the deferred compensation account across a wide range of notional investment funds, subject to certain conditions.

And, the notional fund line-up could include a hard-working strategy we developed called the **collared-index option** to allow allocation to the equity markets with downside protection.

The flat returns of the 2000s, made worse by the 2008 Great Recession, caused a 37 percent decline in NQDC account balances. Naturally, executives get nervous twitches at the prospect of future market swings. However, you can avoid deflated account balances or the unwanted possibility of postponing retirement. See the chart below for a better understanding of the full impact of the collared index.

S&P 500 TOTAL RETURN w & w/o Collar - 2000 thru 2009 (10 Years)



Indices are unmanaged and investors cannot invest directly in an index.

Our collared index puts a floor on negative returns in exchange for an acceptable cap on positive returns, stabilizing peaks and valleys in market performance. While allocating funds to an account that tracked the S&P 500 (excluding dividends), you can eliminate market losses with a minimum 0% return in exchange for a cap on any one year's growth at nine percent.

Using this modified approach (floor of 0%, cap of 9%) during the decade of the 2000's, an executive with a $1 million starting balance could have achieved a **4.17 percent return** compounded annually, compared to a loss of .95% without the floor and cap.

When you add the collared-index option to NQDC plans, you minimize **two executive fears**: 1) fear of suffering significant losses from market declines; and 2) fear of being out of the market and missing upside returns. Adopt this strategy, and you snap the executive back into thinking like a long-term owner. It gets even better.

The Coup de Gras

If an executive owns substantial holdings of restricted stock or RSUs, he could suffer significant losses in a volatile market. In fact, many executives hold large concentrated equity positions in their comp packages due to stock ownership guidelines, restrictions, tax considerations, or the uncomfortable corporate optics of not doing so.

According to J.P. Morgan Asset Management, 320 stocks have been removed from the S&P 500 since 1980 due to "business distress," and 40 percent of Russell 3000 stocks have suffered a permanent decline of 70 percent or more from the peak value. Downside risk demands attention. Sure, ways to mitigate risk exist but limitations abound:

- Outright sale of the stock
- Exchange funds
- Put options
- Stop-loss orders
- Securities-backed loans
- Equity collars
- Prepaid variable forwards

Find your solution in a new strategy, known as the **Stock Protection Fund** (SPF), created recently by StockShield, LLC. An SPF mutualizes the downside risk of your concentrated holding across a group of diversified investors, building a pool of liquidity to compensate for losses.

The SPF mutualizing does not touch a single share of the concentrated position; no stock sales required; no encumbrances or lock-ups; no SEC filings or employer restrictions. While you hedge downside risk, you can continue to participate 100 percent in the stock's upside and any dividends.

Or, if you wish, you can sell outright. The secret to the strategy is no more complex than U.S. government bonds and the principal of mutualization. Let's take a moment to explain how the SFP works.

The SPF consists of 20 investors (see figure below) who participate in a limited offering with a pre-set closing. Each investor protects a different stock in a different industry for diversification purposes. They contribute cash (not shares) into the fund, equal to 10 percent of the value of the shares they wish to protect. Then, the fund invests in U.S. Treasuries for a term of five years.

When the bonds mature, the fund terminates, and the cash distributes back to the participants. If the fund exceeds the total of the declines (as illustrated below), those with declines are made whole, and any remainder returns equally to the others.

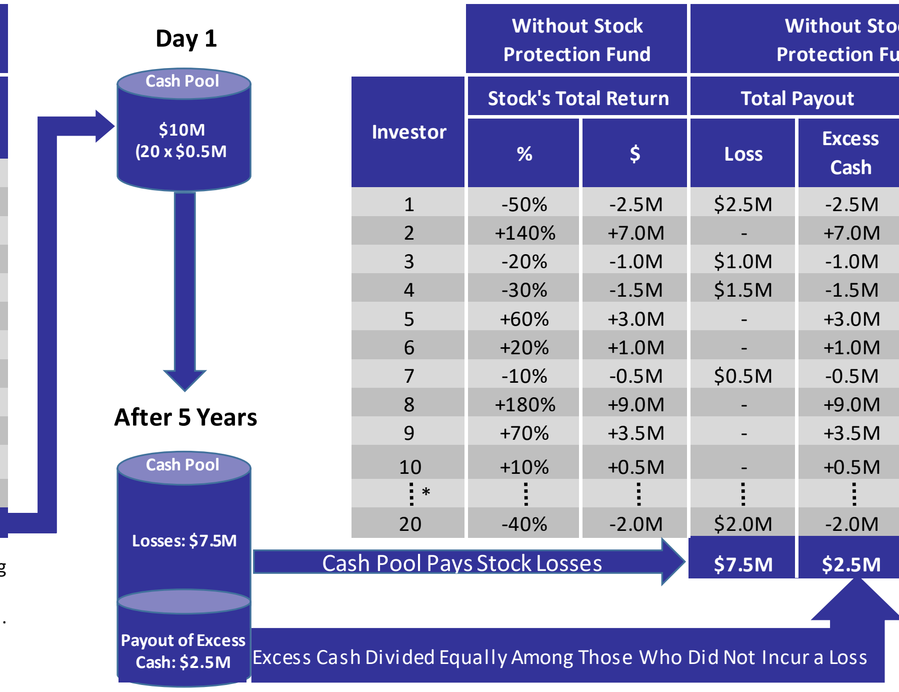
On the other hand, if declines exceed the value of the fund, the decliners may not be made 100 percent whole, but their losses reduce substantially. During the term of the SPF, you are free to sell, gift, leverage or do whatever you wish with your shares. When the term concludes, you can renew your protection with a new fund.

Initially (DAY 1)

20 Investors with 20 Different Stocks		
Investor	**Stock Protected**	**10% Cash Contribution**
1	$5M	$0.5M
2	$5M	$0.5M
3	$5M	$0.5M
4	$5M	$0.5M
5	$5M	$0.5M
6	$5M	$0.5M
7	$5M	$0.5M
8	$5M	$0.5M
9	$5M	$0.5M
10	$5M	$0.5M
⋮	⋮	⋮
20	$5M	$0.5M
TOTAL	**$100M**	**$10M**

Note: Assumes the annual cost of operating the SPF is fully covered (i.e. paid) by the interest income generated by the Cash Pool.

*Investors 11-19 had gains.



AFTER 10 YEARS

	Without Stock Protection Fund		Without Stock Protection Fund		
	Stock's Total Return		Total Payout		
Investor	**%**	**$**	**Loss**	**Excess Cash**	**Total Payout + Stk Value**
1	-50%	-2.5M	$2.5M	-2.5M	-2.5M
2	+140%	+7.0M	-	+7.0M	+7.0M
3	-20%	-1.0M	$1.0M	-1.0M	-1.0M
4	-30%	-1.5M	$1.5M	-1.5M	-1.5M
5	+60%	+3.0M	-	+3.0M	+3.0M
6	+20%	+1.0M	-	+1.0M	+1.0M
7	-10%	-0.5M	$0.5M	-0.5M	-0.5M
8	+180%	+9.0M	-	+9.0M	+9.0M
9	+70%	+3.5M	-	+3.5M	+3.5M
10	+10%	+0.5M	-	+0.5M	+0.5M
⋮ *	⋮	⋮	⋮	⋮	⋮
20	-40%	-2.0M	$2.0M	-2.0M	-2.0M
			$7.5M	**$2.5M**	

Source: The Inverse of Exchange Funds, Thomas J. Boczar and Elizabeth Ostrander; Investments and Wealth Monitor, May-June 2015.

SPF Quick Case Study

On June 1, 2006, twenty investors who owned and wanted to protect stock positions in 20 different industries formed a protection fund with a 10-percent cash contribution and a five-year term.

At the conclusion of the fund five years later, the maximum stock loss was 0 percent, meaning the cash pool eliminated (reimbursed) all stock losses. Of the cash contribution (or premium), 31 percent returned to the investors.

For executives with significant concentrated wealth in company stock, the SPF strategy offers the potential to reduce risk without disturbing ownership of shares or requiring disclosure filings, which makes it a tool worth investigating.

If you remain unconvinced, examine the chart below for actual SPF performance during the down years from 2006 to 2001.

ACTUAL SPF DEPLOYED THROUGH THE FINANCIAL CRISIS, 2006-2011

Investor	Stock Protected	Stock's Total Return % Without SPF	With SPF	Loss Eliminated With SPF
1	Best Buy Co., Inc.	-36.7	0	36.7
2	General Electric Co.	-32.1	0	32.1
3	Toyota Motor Corp.	-24.2	0	24.2
4	Harley-Davidson, Inc.	-18.2	0	18.2
5	Amgen, Inc.	-12.5	0	12.5
6	Eli Lily & Co.	-7.7	0	7.7
7	Goldman Sachs Group, Inc.	-5.3	0	5.3
8	People's United Financial, Inc.	-1.1	0	1.1
9	Boeing Co.	3.3	3.3	N/A
10	Time Warner, Inc.	9.5	9.5	N/A
11	MDU Resources Group, Inc.	11.4	11.4	N/A
12	Microsoft Corp.	18.9	18.9	N/A
13	3M Co.	25.5	25.5	N/A
14	EnCana Corp.	25.6	25.6	N/A
15	UIL Holdings Corp	31.7	31.7	N/A
16	Procter & Gamble Co.	40.2	40.2	N/A
17	E.I. du Pont de Nemours & Co.	49.4	49.4	N/A
18	RLI Corp.	55.8	55.8	N/A
19	Humana, Inc.	56.5	56.5	N/A
20	Dow Jones & Co., Inc.	100.4	100.4	N/A

Source: The Inverse of Exchange Funds, Thomas J. Boczar and Elizabeth Ostrander; Investments and Wealth Monitor, May-June 2015.

While we're not here to argue the merits of equity incentives, we know from decades of anecdotal experience that equity packages work and enhanced stock ownership guidelines improve outcomes. That's why we're compelled to do what we can to augment these tools and create more incentives for long-term ownership thinking.

We also know this: Creating a culture of long-term ownership goes beyond the limits of pay for performance; it goes right to leadership.

Stever Robbins, founder and president of LeadershipDecisionworks, Inc., who works with corporations daily on leadership strategies, sees it this way:

"Perhaps 'think like owners' means we want employees to get the big picture, use good judgment, and keep the company's best interest foremost. A laudable goal, but again unrelated to stock. Lack of big picture thinking is often a leadership void. If you want holistic thinking, share the big picture with people about ten thousand times, coach them to live it every waking minute, and add 'gets the big picture and acts on it' to the yearly performance evaluation on which their bonus is based."

Amazon Weighs In

Perhaps it pays to listen to Jeff Bezos of Amazon, the third richest man in the world (as of August this year). His now legendary shareholder letters offer a treasure trove of insight. Of the five-key business lessons he shared on cnbc.com earlier this year, number three states, "**Make employees think like owners."**

Bezos wrote this back in 1997 in the first Amazon annual letter when he had 614 employees. Today, he employs 230,000 with plans to hire 100,000 more over the next 18 months. He uses stock options as an incentive in hiring.

"We will continue to focus on hiring and retaining versatile and talented employees, and continue to weight their compensation to stock options rather than cash. We know our success will be largely affected by our ability to attract and retain a motivated employee base, each of whom must think like, and therefore must actually be, an owner.''

The CNBC writer sums up the moral of the story: "*Whether it's stock, bonuses or profit sharing, give workers a stake in the success of the company."*

Net Takeaway

If you plan to build a culture of long-term ownership, create a total rewards program for those executives who can make a difference on the bottom line.

That total rewards program calls for ways to make equity packages more abundant for the executives and more air tight for the CEO, directors, and shareholders who want executives to stay put and perform in the long-term interests of the corporation. You accomplish that goal, in part, by adding deferral and diversification features to their NQDC plans.

Of course, we acknowledge long-term ownership thinking demands more than simple revisions to retirement plans. However, they represent an auspicious step toward creating a win-win for the C-suite, directors, shareholders, and value creation for the corporation.

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For more information on enhancing your NQDC Plans through revisions to stock ownership guidelines, please contact one of our Managing Directors near you:

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