The Many Governance Benefits of Mandatory Post-Vest Holding Requirements

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Introduction

Investors are increasingly concerned with equity compensation practices at public companies. Their apprehension is evident in the level of scrutiny applied by institutional investors and proxy advisory firms when deciding whether or not to support management requests for new or amended share authorizations. It is also evident in the consistency with which shareholder proposals are brought forth each year — often by activist investors — to request that companies adopt meaningful stock retention policies for executive officers.

Despite the fact that most companies in the United States (US) have executive stock ownership guidelines, the use of pure equity holding periods is far less prevalent. This is unfortunate, as mandatory post-vest holding requirements can provide a wide range of potential governance and accounting benefits to public company issuers, which include:

- Serving as a risk mitigating feature for executive compensation programs by working in tandem with clawback policies as an enforcement mechanism for the return of incentive awards;
- Helping to further align executive interests with those of shareholders by promoting a culture of long-term executive ownership;
- Increasing the odds of institutional investor and proxy advisory firm support for new or amended share authorization requests, plus reduced risk for a shareholder proposals related to equity grant practices; and
- Delivering meaningful economic value to issuers in the form of accounting valuation discounts applied to equity compensation grants when mandatory post-vest holding requirements are specifically included in award agreements.

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While some will argue that holding periods limit employee flexibility to sell shares once they are rightfully vested or exercised, we believe the number of companies implementing mandatory post-vest holding periods will rise significantly over the next several years. As we see it, companies will be hard pressed to pass up on the favorable optics, positive governance implications and accounting valuation discounts provided by holding requirements once their benefits are more widely understood in the marketplace.

Retention Ratios vs. Pure Holding Periods

There are two common forms of holding requirements used in the US: retention ratios and pure holding periods. Retention ratios are currently more popular, as they provide executives with more flexibility. However, pure holding periods are preferred by investors and proxy advisory firms, and they allow companies to potentially take advantage of applicable accounting discounts.

Both types of holding periods start with an ownership requirement that is stated as a percentage of the "profit shares" resulting from a long-term incentive grant (typically ranging from 50% to 100% of all such shares). Profit shares are typically defined as the shares remaining after (1) the payment of option exercise prices and any taxes owed at the time of exercise; (2) vested restricted stock; and (3) shares earned at the completion of a performance share period. In the case of retention ratios, holding periods are enforced until an existing ownership guideline policy is met. On the other hand, pure holding periods are enforced for a stated period of time, usually one to three years, regardless if ownership guidelines are in place or not.

Proxy Advisor and Investor Implications

Currently, Institutional Shareholder Services (ISS), which is the leading proxy advisory firm in the US market, analyzes the presence of holding requirements for various purposes, including:

- **QuickScore Ratings** — ISS gives companies positive credit in its governance rating system, known as QuickScore, for the disclosure of retention ratios or holding requirements that impact 50% or more of all profit shares.

- **Management Proposals for New or Amended Share Authorizations** — Starting with new or amended share authorization requests made in 2015, the Equity Plan Evaluation Scorecard recently adopted by ISS lists holding periods as one of several factors the firm will consider when making voting recommendations on share plans.

- **Management Say-on-Pay Proposals** — Pursuant to ISS' Problematic Pay Practices Policy, the firm conducts a risk assessment of executive compensation programs before deciding whether or not to support management Say-on-Pay proposals. ISS views the implementation of robust stock ownership guidelines and/or equity holding requirements as a risk mitigating practice. Furthermore, the inclusion of holding requirements on special one-time sign-on, retention, or recognition grants is also considered a risk mitigating design factor.

- **Shareholder Proposals for Stock Ownership and/or Equity Retention Policies** — Naturally, ISS reviews a company's existing ownership guidelines and holding requirements whenever shareholders call for increased equity retention requirements. When existing policies meet ISS standards, the firm is far less likely to support a shareholder proposal.

Aside from proxy advisory firms like ISS, many large institutional investors support equity holding periods in their own proxy voting guidelines. Their internal guidelines, which often do not align directly with ISS policies, frequently come into play for Say-on-Pay votes or management requests for new or amended

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share authorizations. For instance, Vanguard includes the following language on their "Views on Corporate Governance" webpage:

> *"We value stock ownership and retention requirements because we believe that they reinforce executives' "shareholder" mindset. Executives should be expected to maintain a substantial ownership interest for the duration of their employment. Companies should also impose holding-period requirements on shares acquired through option exercise. While we support the use of equity-based compensation as a means to align the interests of employees and other owners, such arrangements should not unduly dilute the value of stock held by public shareholders."*

Conclusion

Given continued scrutiny from proxy advisory firms and institutional investors on equity compensation, and the potential benefits associated with the use of holding requirements, we anticipate more companies will begin incorporating such design features in their future equity grants. However, such benefits can only be achieved through a thoughtful design process that balances both internal company needs and external expectations. Therefore, it is important that companies work through the applicable technical, regulatory, and governance-related implications before finalizing any program changes. As previously noted, many of the benefits associated with pure equity holding periods do not necessarily apply to the more common retention ratio type designs currently used by many companies.

To learn more about the full set of governance and accounting benefits associated with mandatory post-vest holding requirements, please visit holdaftervest.com.

To learn more about the Governance Services practice at Aon Hewitt and Radford, please visit: radford.com/home/consulting/compensation_governance.asp

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About Governance and Technical Services

The governance consulting practice at Aon Hewitt and Radford works with business leaders at companies of all sizes in all industries to understand and assess their potential exposure to the multitude of corporate governance and executive compensation guidelines maintained by shareholder advisory groups and institutional investors to analyze proxy ballot items. The practice provides a wide range of advisory services, including annual governance audits, pay-for-performance modeling simulations, share modeling, stock and incentive plan drafting, and CD&A assistance.

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