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Investor Pressure Boosts CEO Stock Ownership

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By Gavin Pierce

Since the start of 2017, several companies including **Avery Dennison**, **BB&T**, **Chevron**, **Duke Energy**, **GlaxoSmithKline** and **S&P Global** have disclosed increases in their CEO stock ownership guidelines. The purpose of the increases, experts say, is to better align the interests of the CEO with those of long-term investors, to adhere to marketplace best practices and to satisfy shareholder pressure around levels of stock ownership.

Data from **Meridian Compensation Partners** shows that CEO ownership multiples (as a percentage of base salary) rose in 2016 versus what was seen in 2011, and more companies are moving to increase the levels of stock ownership required of their chief executives. The Meridian report states that most companies require their CEO to own company stock worth six times their annual salary, but some boards have decided to exceed those requirements and higher levels required by their peers. There are even some CEOs who voluntarily exceed their mandated ownership levels by a wide margin. Governance experts warn that although increased stock ownership by CEOs is generally viewed positively, there can be times when CEO holdings could become too high and have the opposite effect than what was intended.

Alignment With Long-Term Shareholders

Stock ownership requirements can signal to shareholders that executives are committed to the stock price, which improves alignment with shareholders. "The broad reason for this is to signal to the market that the executives' interests are aligned with shareholders'," says **Equilar** director of client engagement and corporate governance, **Timothy Stark**. "A firm might increase its ownership requirements if they are considered below the mean for their peer group. Or it could be, perhaps, the board 'got religion' around good governance and alignment, and are coming up to par."

As an example of this, in its 2017 proxy, the S&P Global board disclosed that it increased stock ownership requirements for its CEO because the company was "committed to ensuring that our executive officers have a significant ownership stake in the company to strengthen the alignment of our executives' interests with those of our shareholders."

According to commentary from **Semler Brossy Consulting Group** provided in a report from Equilar, stock ownership requirements could also play a role in securing shareholder support when justifying pay packages. "Overall, companies with high levels of executive pay, large one-time equity awards or low say-on-pay votes have an even greater expectation from shareholders that the ownership policies will be aggressive," says **Seamus O'Toole**, managing director at Semler Brossy, who was cited in the report.

Shareholder insistence that CEO stock ownership levels can play a role in improving a company's long-term performance is a key reason stock ownership requirements are on the rise. In fact, **Aalap Shah**, managing director at **Pearl Meyer**, says the pressure to increase ownership guidelines is coming exclusively from the investor side and "the directors are ... reacting to what the institutional shareholders would like."

In recent years, institutional investors have pushed boards to increase their long-term focus, as evidenced by **BlackRock** CEO **Larry Fink**'s annual letter to CEOs. Additionally, **Matteo Tonello**, managing director of corporate leadership at **The Conference Board**, notes, "One tool used by boards and their compensation committees to promote long-termism is stock ownership requirements."

For many years, five times salary was considered the standard ownership requirement for most CEOs, according to a report by **Willis Towers Watson**. Six times base salary for CEO stock ownership is now the standard for most companies.

"The five times number is largely a legacy threshold, a multiple that has been used for many years and, once upon a time, was a fairly good measure," writes **John Roe**, managing director and head of **ISS Analytics**, in an e-mail. "Having a five-times multiple in place meant that the CEO had to make a sizable commitment to buying and owning company stock (or at least to holding onto multiple years of grants)."

However, the five-times multiple is barely seen as adequate for a CEO today. Roe points out that CEO base salaries have stalled at larger companies in recent times (due to deductibility issues), while equity grants continue to grow almost unchecked. Therefore, "a five times multiple applied to a base salary is becoming less meaningful than it once was," according to Roe.

The increase from the five-times to the six-times stock ownership multiple is largely a reflection of increasing CEO pay. "What we have been seeing in the last few years is a massive shift towards the use of full-value stock grants," Tonello says. "The problem with generous stock grant packages is that they pay out over a much shorter period of time than the typical stock option award, and boards have started to use stricter and stricter ownership guidelines to compensate for this feature of the stock grant and to justify larger and larger stock grants."

Tonello says the six-times multiple has become the standard because it generally signals the company's commitment to own its own stock and justifies the rapid increase of stock grants that has occurred over the last few years.

Exceeding Industry Standards

Experts also say that industry best practices and peer emulation play a role in some boards' decisions to increase stock ownership requirements.

"Once the norm [or best practice] is established, other followers and late adopters look to peers to benchmark what's appropriate, so it continues to reinforce the norm," writes **Robert Newbury**, director of executive compensation resources at Willis Towers Watson.

For example, Avery Dennison disclosed in its 2017 proxy that it moved to a six-times multiple in order to make its ownership guidelines more rigorous and consistent with market best practices. In fact, BB&T, Duke Energy and S&P Global also moved to the six-times level this year.

However, some companies are looking to set themselves apart from peers, according to a Willis Towers Watson report, and they have gone beyond the recommended requirements. “Stock ownership guidelines have become so ubiquitous that more rigorous guidelines are increasingly required to create a meaningful link between shareholder and executive interests that stands apart from competitors and peers,” the report states.

According to Tonello, large stock grants are driving some firms to raise ownership guidelines above median levels. “Most companies that do not fall into the median range of five to six times base salary actually set their ownership requirement much higher than that — at eight, nine or even 10 times the base salary,” he says. “What we see is that the more generous the stock awards or the total compensation level ...[,] the stricter the ownership requirements set by the company’s guidelines.”

Some large-cap boards, which tend to award larger amounts of stock grants, are implementing CEO ownership guidelines that exceed the industry median. Among **Dow 30** components, **GE**, **Goldman Sachs** and **Microsoft** have all moved to stock ownership multiples equal to 10 times annual salary. Incidentally, this corresponds with the minimum level that ISS considers as “rigorous.”

The CEO of **General Dynamics** is subject to stock ownership guidelines of 15 times base salary, one of the largest. “In order to emphasize a culture of ownership and strengthen management’s alignment with long-term shareholder interests, the Committee requires one of the strictest set of stock ownership guidelines in our industry for the NEOs,” according to the company’s 2017 proxy.

Wal-Mart CEO **Doug McMillon** owns stock equal to 43.4 times his base salary versus the company requirement of seven times salary. At **United Healthcare**, CEO **Stephen Hemsley**’s stock holdings equaled 424 times his base salary as of March. This amount exceeds the required eight times base salary and is up from 312 times in 2015.

Can a CEO Own Too Much Stock?

As CEO stock holdings have risen since the Great Recession, experts say there is a point where a CEO’s equity stake in his or her company could become too large.

“You don’t want [stock holdings] to be so high that it becomes a source of angst in a way that’s counterproductive to the company, which also potentially implicates short-term performance or short-term actions,” says **Charles Elson**, director of the Weinberg Center for Corporate Governance at the **University of Delaware**.

David Larcker, a professor at **Stanford Law School**, writes that if most of a CEO’s wealth is concentrated in their company, the lack of diversification could make them risk averse in a way that could impact the corporate strategy. “This might mean that they select safe (but low return) investments, whereas shareholders are diversified and they want executives to select investments with higher expected value and risk. There is always a delicate balance here. The board needs to think about this incentive when setting executive pay."

Shah expands on that point, explaining that if large company stock holdings greatly limit diversification in a CEO’s wealth creation portfolio, that individual could become too focused on the stock price. “The more onerous these guidelines get, the more locked into the overall value of the company the individual is … up to a point that’s a good thing, but you’re going to get diminishing returns after a point. Then you’re potentially gaming strategy [and] gaming financial results to ensure that the stock price has the gains that you need,” Shah says.

To counteract these issues, when CEO stock holdings get to the point where the executive is sufficiently aligned with investors, boards should consider changes to the design of the long-term incentive plan, says **Eric Larre**, a partner specializing in executive compensation at **Mercer**.

“If top executives are already aligned with shareholders via significant personal share holdings, why not focus the incentive plan design around things they can really manage, like sales growth, Ebitda, EPS, return on invested capital or other financial metrics, over which they have much more power than stock price?” he says.