The Many Governance & Cost–Savings Benefits of Mandatory Post-Vest Holding Requirements

By Laura Wanlass and Chris Fischer

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 to support management requests for new or amended share authorizations. It also is evident in the consistency with which shareholder proposals are brought forth each year, requesting that companies adopt meaningful stock retention policies for executive officers.

Despite the fact that most companies in the United States 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 shareholder proposals related to equity grant practices; and
- Delivering meaningful economic value to issuers in the form of lower financial accounting expense as a result of valuation discounts that are applied to equity compensation grants when mandatory post-vest holding requirements are specifically included in award agreements.

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Governance Considerations

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. Pure holding periods are preferred by investors and proxy advisory firms, however, 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 percent to 100 percent of all such shares). Profit shares are typically defined as

(1) the shares remaining after the payment of option exercise prices and any taxes owed at the time of exercise;

(2) vested restricted stock net of shares used to satisfy withholding requirements; and

(3) shares earned at the completion of a performance share period net of shares used to satisfy withholding requirements.

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 of whether ownership guidelines are in place or not.

Currently, Institutional Shareholder Services (ISS) analyzes the presence of holding requirements for various purposes, including:

- QuickScore Ratings—ISS gives companies positive credit in its governance rating system for the disclosure of retention ratios or holding requirements that impact 50 percent 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 to support management Say-on-Pay proposals. ISS views the implementation of robust stock ownership guidelines and equity holding requirements as a risk mitigating practice.

- Shareholder Proposals for Stock Ownership and 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.

Many large institutional investors support equity holding periods in their own proxy voting guidelines. Their internal guidelines frequently come into play for Say-on-Pay votes or management requests for new or amended share authorizations.

SEC and FASB Disclosure Requirements

Although the prevalence of mandatory post-vest holding requirements increases each year as companies strengthen the corporate governance aspects of their equity programs, an often overlooked benefit is illiquidity discounts. Yet, in our experience, disclosures related to discounts for illiquidity generally lack the rigor that one might expect under applicable accounting rules. Too often, the information provided by companies does not go far enough to provide either the "significant assumptions" or the "method" used for estimating discounts. The remainder of this article examines the Accounting Standard Codification Topic 718's (ASC 718) disclosure requirements related to illiquidity discounts, as well as our opinion on "best practices" to pursue at your organization.

Under rule ASC 718-10-55-2, the minimum disclosures required for an award of equity-based compensation are as follows:

For each year for which an income statement is presented, both of the following are required:

1. A description of the method used during the year to estimate the fair value (or calculated value) of awards under share-based payment arrangements

2. A description of the significant assumptions used during the year to estimate the fair value (or calculated value) of share-based compensation awards, including (if applicable):
   a. Expected term
   b. Expected volatility
   c. Expected dividends
   d. Risk-free rate(s)
   e. Discount for post-vesting restrictions and the method for estimating it.

Even the most basic disclosure requirements for equity-based compensation contemplate the potential for post-vest selling restrictions. As a result, ASC 718 explicitly requires the disclosure of both the methods used to estimate an illiquidity discount and all of the assumptions used in the analysis. Issuers are increasingly rigorous in their disclosure of the assumptions and methods used to value option awards and performance-based equity grants, and have similar room for growth when it comes to the illiquidity discounts created by mandatory post-vest holding requirements.

Estimating Illiquidity Discounts

Most valuation practitioners apply theoretical option pricing-based models to estimate illiquidity discounts. Multiple mathematical models are available for use, the most prominent of which are the Chaffe and Finnerty models. Both approaches consider the specific duration of the restriction period created by a mandatory post-vest holding requirement and the volatility of the underlying stock when estimating potential illiquidity discounts.

Given the fact that illiquidity discounts are almost always estimated using an option pricing model, we believe the disclosures necessary to satisfy the requirements of ASC 718-10-55-2 are analogous to the disclosure requirements related to employee stock options. The disclosure should identify the model or models used to develop the illiquidity discount, as well as the assumptions used with the model. Taking these items into account, we believe the following disclosure sample satisfies the requirements of ASC 718-10-55-2:

The Company periodically grants time vested restricted stock units (RSUs). The RSUs vest over a period of three years following the date of grant. The shares of Company stock underlying the RSUs will be distributed on the second anniversary of the vest date. During the period between the vest date and the distribution date the employee may not sell or otherwise dispose of the shares. The Company has applied a discount for illiquidity to the price of the Company's stock when determining the amount of compensation expense to be recorded for the RSUs. The discount for illiquidity for each RSU is estimated on the date of grant using the Chaffe model and the Finnerty model, and the assumptions noted in the following table. Based on the relative strengths of each model, a 60 percent relative weighting was applied to the discount developed with the Chaffe model and a 40 percent relative weighting was applied to the discount developed with the Finnerty model. Expected volatilities are based on implied volatilities from traded options on the Company's stock. The expected dividend yield assumptions are based on the dividend yield on the Company's stock as of the date of grant. The risk-free rates are based on the US Treasury yield curve in effect at the time of grant. The weighted-average grant-date grant illiquidity discount during the years 2014, 2013, and 2012 was 12.4 percent, 13.7 percent, and 15.1 percent, respectively. The weighted average grant date fair value of RSUs granted during 2014, 2013 and 2012 was $82.06, $64.55, and $56.53, respectively, after the application of the illiquidity discount.

In our view, this disclosure example aligns with the intent of ASC 718-10-55-2 because it specifically calls out the size of the illiquidity discount, the models used to estimate the illiquidity discount, and the assumptions used in the analysis. Unfortunately, examples of this quality are few and far between, suggesting that issuers have ample room for improvement.

Conclusion

We anticipate that continued pressure from institutional investors and proxy advisory firms on corporate governance issues, coupled with the financial accounting benefits of illiquidity discounts will contribute to increased adoption of mandatory post-vest holding requirements over the next three to five years. As the popularity of this practice accelerates, however, so too will scrutiny from auditors and regulators. When it comes to realizing the benefits of illiquidity discounts, companies will need to be more rigorous in the valuation techniques, assumption development and disclosure practices. To that end, we counsel companies considering mandatory post-vest holding requirements to carefully review the disclosure example as a best practice model, and to review their valuation approach.