Can Corporate Officers Sell Stock?

INTRODUCTION

Conventional wisdom has it that a greater portion of pay in the form of company stock and greater requirements to hold that stock are a good thing when it comes to the pay of corporate executives. Trends have borne out the implementation of this conventional wisdom. The latest pressure from proxy advisory firms and shareholder activists emphasizes mandatory holding periods even after equity pay is vested, with some calling for the forced holding of stock into retirement.

The call for executives to hold company stock is not only from the outside. An ethic to build and retain ownership has been a hallmark in many companies and across all industries. In the modern era, Sandy Weill was noted for introducing share retention requirements for his executive team as he assembled the empire that eventually became Travelers and Citigroup. That practice has since been adopted widely on Wall Street and in money-center banks and has moved well beyond into companies in other industries. The principle of long-term alignment with shareholders is compelling.

But often left out of consideration is when is “more” equity holding too much? Today’s corporate officer is likely to be exposed to high concentration risk in the single security of the company for which they work. The psychological pressure this creates hits executives unevenly, to be sure. For some it no doubt sharpens the mind. For others it seems to lead to undue stress and dysfunction.

WHAT’S THE BIG IDEA?

With increasing pressure to require corporate officers and other executives to hold company stock, a concurrent articulation of principles and a process for the sale of company stock is important. Principles should include:

- A concentrated position in company equity is desired, expected and required by company policy.
- Recognition that diversification of wealth is healthy and appropriate means that executive selling under approved processes is supported.
- Companies should adopt more than legal processes to support and aide corporate officer stock sales — including a process to inform and advise the Board or its Compensation Committee and to explain proactively to investors.
Unfortunately, the pressure from excessive concentration of risk is likely to strike hardest when clear thinking, fast response, and strong leadership are needed the most. During the market’s free-fall in 2008 and amid fear of the financial system failing, we observed executives challenged to remain clear-headed as fears of personal financial calamity weighed down heavily.

Executive officers generally start from a position that they cannot sell company stock, at least not easily. Consider that to do so: First, they must be in compliance with their company’s own share ownership guidelines or retention and holding requirements. Second, they can’t act unless they are within an approved trading window (especially difficult for acquisition-oriented companies who may rarely have an open window). Third — and often the toughest, especially for many CEOs and CFOs — there is a strongly held belief that any selling will signal to the market a weakening of confidence in the future.

It’s no surprise then that we consistently hear executives maintain that “I can’t sell stock.” Or, “I can’t sell stock until I leave,” and its sometimes corollary, “I feel that between the rules and the pressure not to sell I am being encouraged to leave here in order to be responsible to my family regarding our finances.”

But Do Corporate Officers Sell Stock?

Does this pressure not to sell reflect reality? We recently researched corporate officer stock selling among the 100-largest S&P 500 companies over the last five years (2007-2011) to understand what actually happens. Corporate officers may feel hamstrung, but do they nonetheless find ways to sell and diversify anyway? In fact, they largely do, but with some restraint.

In particular we focused on CEOs who were not founders and who had at least moderate tenure. We excluded CEOs of financial services firms due to the significant volatility of that sector and TARP regulations, which would likely distort the picture.

**Signaling from CEO Stock Sales — Not All It’s Cracked Up to Be**

When CEO’s sell stock, is there a “signaling” effect?

Among our sample of S&P 500 CEOs, we analyzed the effect of stock sales in excess of $1MM on company stock price. We conclude that the perceived market signaling is unfounded; CEOs sold stock to their own detriment – i.e., in advance of positive performance – more often than not.

We found that in over 60% of cases, company stock generally appreciated in the 90-days following the sale of stock and actually outperformed compared to the market. Even when removing for periods of excess market volatility (i.e., where the S&P 500 index appreciated or depreciated more than 20%), company stock appreciated following the CEOs sale in the vast majority of cases.

**Did company stock outperform relative to market in 90 days following a stock sale?**

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<th>All observations</th>
<th>Excluding shock periods*</th>
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<td><strong>Outperformed</strong></td>
<td><strong>Underperformed</strong></td>
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* Shock periods defined as periods where S&P 500 moved +/- 20% in 90 days.
Among the sample, 28 companies are led by CEOs who fit our criteria:

- Between 5 and 10 years of tenure
- Non-founders
- Non-financials

Roughly 70% of these CEOs have sold stock at least once during the five years from 2007-2011, and over 45% sold stock in three out of the five years. In other words, the sale of stock is far from uncommon (Fig 1).

Given the prevalence of selling stock among CEOs, one might expect that even more would have sold stock in all five years if not for the severe stock market conditions in parts of 2008 and 2009. Interestingly, while there is clearly some “lag effect” from market conditions, the number of CEOs selling in any given year still only modestly corresponds to the general conditions of the stock market. In each of the years reviewed, at least 30% of the CEOs in our sample sold some stock, as shown in Figure 2.
How much money did those CEOs who sold stock actually make? Pre-tax sales proceeds varied considerably among these S&P 500 CEOs. However, relative to the CEO’s total holdings — that is, their outright ownership plus the intrinsic value of any options outstanding and other unvested shares — sales were meaningful but represent only a minority of ownership value (Figs 3 and 4).

In other words, CEOs sold equity, but most still had far greater “carried interest” in their company’s stock.

Most of the CEOs in this study have spent a good portion of their careers with their companies. As a result, their equity holdings and share grants have accumulated for longer periods than their tenure as CEO. At the end of 2011, not one of them had equity value remaining of less than $30MM and six had equity value exceeding $100MM. Nonetheless most had managed to sell company stock during the prior five years.
Should Corporate Officers Be Able to Sell Stock?

With mandatory requirements to hold stock — along with the rules that restrict how and when shares can be sold — we believe it also makes sense for companies to articulate an affirmative principle that stock can be sold.

In a trend that began about twenty years ago, over 85% of companies have adopted share ownership guidelines that require senior officers to attain minimal levels of ownership, generally expressed as a dollar value multiple of the officer’s salary. Some companies have added additional restrictions that once delivered, equity must be held for an additional year or two and still others have adopted share retention guidelines. (See our Advancing the Dialogue on holding requirements: “The Benefits of Holding Requirements for Equity Incentive Plans” for additional discussion). By whatever means, companies should adopt guidelines or requirements that are best suited to them and in so doing affirm that — by design — a concentrated position in company equity intends to align executive interests with those of long-term shareholders.

How, then, should the flip side — diversification — be supported? Given the restrictions and “negative optics” of executive share sales, companies have in the past condoned margin lending by executives against their stock holdings. While expedient, this approach has been shown to have risks. In several high profile cases, forced sales by executives to meet margin calls have come at exactly the wrong time, i.e., when market confidence in the company or its sector was already free-falling. Executive judgment may also be impaired in face of a potential margin call. Thus it seems prudent to restrict or severely limit the degree to which at least corporate officers (i.e., those for whom stock sales are required to be disclosed) can pledge or margin their company holdings.

With so much pay in the form of equity instruments, it is fair and reasonable to expect corporate officers to be able to realize some of its value during their tenure — not just after their tenure. Diversification is a reasonable approach to manage personal finances. While limiting the upside, it also limits downside risk and has a greater chance of preserving value.

Accordingly, companies should take affirmative steps to support some level of diversification through stock sales.

Supporting Stock Sales the Right Way

In our experience the optimal conditions for corporate officer stock sales meet three tests:

1. **In Compliance with Insider Trading Rules.** Companies should consider 10b5-1 plans which, if appropriately structured, protect against the risk of insider rule violations while still providing multiple paths for stock selling. Our research indicates that about 20% of larger-cap companies disclose that 10b5-1 plans are in place. But this disclosure is entirely voluntary and probably under-reports the prevalence of this practice.

   This paper does not purport to cover the legal implications of corporate officer stock selling. Nonetheless we believe 10b5-1 plans are an effective and useful tool and that companies should establish their own “guard rails” for how they are used. (In the absence of a company policy, a corporate officer could create their own 10b5-1 plan).

2. **Transparent to Investors.** An effective communication to investors and analysts may be specific to the circumstances of the company and the executives doing the selling. But the need for any explanation can be mitigated...
by the presence of two company policies: a clearly communicated share retention guideline and a voluntary
disclosure of the presence of 10b5-1 plans. In tandem these two items indicate the company’s commitment and
expectation that officers hold a concentrated position in the company’s shares while also explaining that orderly,
compliant selling can and will occur over time.

3. Transparent to the Board. Although it may be surprising to some, our experience has taught us that the more
negative surprises around officer stock selling occur between management and the board — more so than the
potential negative effects in the stock market from perceived signaling. Often board members are as or more
likely to perceive signals from executive sales than Wall Street. Also, in the absence of a process for notifica-
tion, board members can be surprised to hear of sales only after the fact and perhaps first when reported by
the press who have picked it up from filings. We advocate an approach where the Compensation Committee
is informed by management of potential or intended activity by corporate officers. Unusual or significant sales
— especially by the CEO or CFO — may also warrant advisement to the full Board.

Corporate officer stock sales are an open book once they’ve occurred and are disclosed in Form 4s. Companies
should recognize the fairness and efficacy of stock sales, not just from a legal perspective, but also as a matter
of corporate policy, investor relations, and the board/management relationship. By addressing this matter affirmatively — and before sales occur — companies can achieve a positive outcome for themselves and their officers.

In Summary

Most of the attention in corporate governance has been focused on whether executives are holding enough stock
to align their interests with the interests of shareholders. As a result, the converse has become conventional
wisdom — that executive stock sales must be “bad” and should not be encouraged. As usual, the reality is more
nuanced than this conventional wisdom would suggest. Indeed, for long-serving executives, there is a real
danger that too much concentration of wealth can affect behavior and make an executive either risk-adverse or —
perhaps even more damaging — encourage excessive risk taking to save their personal wealth in the short-term
at the expense of longer-term shareholder value.

As a result, corporate boards can and should monitor stock holdings for senior executives and encourage moder-
ate, appropriate, and transparent diversification over time. Such sales are actually more common than might be
expected and, if done in the right way, support a balanced approach to managing rewards, risks, and continued
alignment with shareholder interests.

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