Pledge (and Hedge) Allegiance to the Company

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October 11, 2010

EXECUTIVE PLEDGING AND HEDGING

A significant portion of executive compensation is paid in the form of equity. Companies include equity in a compensation package to align the interests of management with those of shareholders. If the executive performs well, both shareholders and the executive will profit; if the executive performs poorly, s/he will suffer financially along with shareholders. In this way, equity compensation is expected to encourage a focus on long-term value creation.

It is common for an executive who has been employed at a company for many years to accumulate a substantial dollar ownership position in the company. For example, the median level of equity ownership for CEOs in the 100 largest firms is about $48 million. The median level of equity ownership across the 4,000 largest companies is $580,000. Sizeable ownership positions tend to comprise a considerable percentage of an executive’s total personal wealth.

Large equity ownership positions can produce desirable incentives because they constitute “skin in the game.” At the same time, holding an undiversified portfolio of wealth may encourage an executive to become excessively risk averse. In this case, the CEO might pass up promising (but risky) investments in order to select safer investments with lower potential payoff. This is detrimental to diversified shareholders that expect a balance of risk and reward.

With concentration of wealth in a single financial asset, an executive may want to limit his or her exposure. It is also conceivable that the board may also encourage diversification if they believe that concentrated exposure can lead to excessive risk aversion. There are at least three ways to do so: the executive can 1) sell shares outright, 2) hedge a portion of the ownership position through financial instruments (such as a prepaid variable forward or zero-cost collar), or 3) pledge a portion of the ownership position as collateral for a loan which is used to purchase other assets (see Exhibit 1).

All of these actions allow executives to diversify or consume a portion of their holdings. However, for many reasons, the executive may prefer to hedge or pledge equity, rather than pursue an outright sale. First, hedging and pledging can be more tax efficient because they allow for the deferral of gains into future years (i.e., taxes on gains are due upon sale of shares, but there are no taxes when a hedge or pledge is executed). Second, if executives believe their company stock is undervalued, pledging shares in return for a low-cost loan will allow them to achieve diversification without disposing of the asset at depressed prices. Third, hedging may allow executives to escape public scrutiny. While the media tends to report significant sales by insiders, it is less likely to report a hedging transaction that achieves the same economic result (these transactions can be difficult to discern from public Form 4 filings).

At the same time, there are potential downsides to allowing executives to hedge. First, hedging unwinds the incentives imposed on management by the board. Hedging converts performance-based compensation into less risky (perhaps riskless) compensation. If the board had originally intended this arrangement, it would have awarded cash instead of equity incentives in the first place. Second, hedging is inefficient for the company. Management often demands a premium for receiving equity
compensation in lieu of cash, but through hedging the executive is still able to convert the value of that premium into cash. This causes the company to overpay relative to its opportunity cost.\(^5\)

Third, academic research has shown that executives who hedge tend to do so before a material decline in the company stock (and generally following a period of strong outperformance).\(^4\) As such, executives may rely on information advantages relative to shareholders to time the placement of hedges.\(^7\) For example, on July 19, 2008, Keith Olsen, CEO of Switch & Data, entered into a prepaid-variable forward contract, exchanging 150,000 shares for $2.2 million in cash. This represented approximately 25 percent of Olsen’s equity holdings.\(^8\) At the time, Switch & Data stock sold at $18 per share. The contract effectively locked in the value of Olsen’s holdings at an 18 percent discount to prevailing market prices. By the end of the year, Switch & Data stock was trading at $7. While the executive may not have known that the price of the stock would subsequently go lower, the timing was certainly favorable (see Exhibit 2).

Finally, the board may wish to limit hedging by executives because it is extremely difficult to explain to shareholders why such actions are permitted. Hedging fundamentally requires an executive to take a short position on their own stock, which seems counter to shareholder interests.

According to our recent survey, about 25 percent of firms allow either pledging or hedging by executives.\(^9\) Of the firms that allow pledging or hedging, 79 percent allow executives to pledge their shares, but only 29 percent allow hedging. From roughly 2006 to 2009, there were 982 directors or officers that reported a pledge in the beneficial ownership section of the proxy statement. The size of these transactions is also quite large: the average pledge transaction involved 44 percent of their total holdings.

Bettis, Bizjak, and Kalpathy (2010) examine hedging transactions reported by 1,181 executives at 911 firms between 1996 and 2006. The typical executive hedges about 20 to 30 percent of their ownership (far in excess of the typical insider sale). They find that executives tend to place hedges after the company share price has made significant run-ups relative to the market. They also find that zero-cost collar and prepaid variable forward hedges tend to precede significant declines in the company share price, which may signal that executives are acting on inside information.\(^10\)

**CORPORATE POLICIES ON EXECUTIVE HEDGING**

Many companies explicitly limit hedging practices through their Insider Trading Policies (ITP). Disclosure is not uniform across companies, however, and in some cases it is not clear whether the board does or does not allow the practice (some companies make no mention of hedging in the ITP and others do not disclose the ITP to the public – see Exhibit 3 for examples of companies that do make this disclosure).\(^11\)

**WHY THIS MATTERS**

1. The recent Dodd Frank Financial Reform Act will require firms to publicly disclose whether they allow executives to hedge. Can boards currently explain why they allow such practices, or the conditions under which they are appropriate? Are boards prepared to forbid hedging if they determine that it is counter to the interests of shareholders?

2. Current practices suggest that many boards do not seem to factor hedging and pledging into their compensation plans. If executives are engaging in these transactions for diversification, why do boards continue to grant new equity each year and not replace that portion of the compensation package with cash?

3. Survey data suggests that only 50 percent or so of pledging and hedging transactions require approval by the general counsel. Given the controversial nature of these transactions, should general counsel approval always be required for pledging and hedging transactions?

4. Survey data also suggests that only about 30 percent of companies currently publicly disclose their insider trading policy. Why are these policies considered proprietary by the board? ■
For firms with fiscal years from June 2008 to May 2009, approximately 40 percent of CEO expected compensation was obtained from stock options and restricted stock. Source: Equilar Inc.


Conversations with senior private wealth managers suggest that executives use the proceeds from hedging/pledging transactions to invest in new businesses, pay for college tuition, remodel their homes, make other large purchases, pay down personal debt, diversify their investments into a basket of stocks, or diversify their investments into riskier assets such as private equity or hedge funds.

However, executives run the risk that such investments do not work out as planned. For example, Aubrey McClendon, CEO of Chesapeake Energy, was forced to sell 31.5 million shares (94 percent of his holdings) in October 2008 after receiving a margin call. He had pledged his shares as collateral in a margin account to purchase additional shares of Chesapeake. The move backfired, however, when the market collapsed during the financial crisis, and McClendon was forced to sell shares at a steep discount. While analysts at the time claimed the company would not be affected, the board later awarded a special bonus of $75 million to McClendon to partially replenish his holdings. Obviously, this type of adverse outcome presents special difficulties for the board and their fiduciary responsibility to shareholders. Source: Ben Casselman, “Chesapeake CEO Sells Holdings,” (Oct. 11, 2008) and “Chesapeake Energy Chief to Remain,” (Jan. 8, 2009), The Wall Street Journal.

Assume that a CEO requires compensation of $1 million. The board can offer either cash or equity. However, because equity has uncertain value, the executive will require a premium relative to cash (say, $1.2 million in expected value of stock options versus $1 million riskless cash). While the CEO may be indifferent between these two forms of payment, if s/he immediately hedges the options, the $1.2 million in risky compensation will be converted to $1.2 million in riskless cash (less transaction costs). In this case, the board overpaid because it could have satisfied the CEO with $1 million in cash rather than the $1.2 million in equity it gave up.


Alternatively, they may simply “sell into strength.”

Switch & Data, form 4, filed with the SEC Jun. 23, 2008; form DEF 14A, filed with the SEC, Apr. 29, 2008.

Corporate Secretary Magazine and the Rock Center for Corporate Governance at Stanford University, “2010 Executive Hedging and Pledging Survey,” (forthcoming).


SEC rules (implemented in 2006) require that companies disclose whether executive shares are pledged to a brokerage account or used as collateral for a loan. The disclosure is included in the annual proxy. By contrast, hedges must be found by going through Form 4 filings by executive after each transaction. These are difficult to search and may be burdensome for investors to go through manually. Historically, there has been no requirement that firms disclose in the company proxy whether they allow executives to hedge. The Dodd-Frank Financial Reform Act, however, requires companies to disclose this information going forward.

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The Stanford Closer Look Series is a collection of short case studies that explore topics, issues, and controversies in corporate governance and leadership. The Closer Look Series is published by the Center for Leadership Development and Research at the Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University. For more information, visit: http://www.gsb.stanford.edu/cldr.

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EXHIBIT 1 — EQUITY OWNERSHIP: METHODS OF DIVERSIFICATION

TYPES OF HEDGES AND PLEDGES

Pledged Shares: shares that are used as collateral for a loan. Title to the shares remains with the executive, but these shares may be subject to sale if necessary to settle the loan to which they are attached as collateral.

Prepaid Variable Forward (PVF): contract that allows the original owner to obtain immediate cash in exchange for a commitment to surrender shares or cash value at a predetermined future date. The actual number of shares to be sold depends on the future market price of the stock, subject to maximum and minimum thresholds.

Zero-Cost Collar: series of trades involving the simultaneous purchase of a put option and sale of a call option with a lower strike price. The proceeds from the sale of the call are used to purchase the put.

Exchange Traded Funds: allows an investor to exchange his or her large holding of a single stock for units in a pooled (diversified) portfolio.

Equity Swap: an agreement between two parties to exchange cash flows associated with the performance of their specific holdings. The arrangement allows each party to diversify its income while still holding the original assets.

OTHER TRADING METHODS

10b51 Plans: trading plan under which executives enter a binding contract that instructs a third-party broker to execute purchase or sale transactions on behalf of an insider. The plans are named after SEC Rule 10b5-1 which provides safe haven to executives that follow certain rules when trading company stock.
EXHIBIT 2 — EXAMPLES OF FAVORABLE HEDGES

SWITCH & DATA (2008)

CEO enters prepaid variable forward contract on 150,000 shares, 24 percent of his holdings.

CHATTEM (2007 - 2008)

CEO enters zero-cost collar agreement on 60,000 shares, 7 percent of his holdings.

Source: Center for Research in Securities Prices (University of Chicago).
EXHIBIT 3 — EXAMPLES OF INSIDER TRADING POLICIES THAT RESTRICT OR PROHIBIT HEDGING

CRIMSON EXPLORATION

Hedging Transactions. You may not engage in certain hedging transactions with respect to Company securities. Certain forms of hedging transactions, such as zero-cost collars and forward sale contracts, allow a stockholder to lock in the value of his or her stock holdings, often in exchange for all or a portion of any future appreciation in the stock. The stockholder is then no longer exposed to the full risks of stock ownership and may no longer have the same objectives as the Company’s other stockholders. Therefore, such hedging transactions are prohibited under this policy.

Margin Accounts and Pledges. You may not hold Company securities in a margin account, and you may not, without prior approval, pledge Company securities as collateral for any other loan. Because a broker is permitted to sell securities in a margin account if the customer fails to meet a margin call, the securities can be sold at a time when the customer is aware of material nonpublic information about the Company. Also, a foreclosure sale under any other loan could also occur at a time when the borrower has nonpublic information about us. Therefore, you may not hold Company securities in a margin account or pledge Company securities as collateral for a loan. An exception to this prohibition may be granted in the case of a non-margin loan where you are able to clearly demonstrate the financial ability to repay the loan without resorting to the pledged securities. A request for any such exception must be made to the Compliance Officer at least 10 days in advance of entering into the pledge agreement.

Source: Crimson Exploration Insider Trading Policy.
Available at: http://crimsonexploration.com/default/Insider_Trading_Policy_Preclearance_3_1_2010.pdf.

NETFLIX

A short sale is a sale of securities not owned by the seller or, if owned, not delivered. Transactions in put and call options for the Company’s securities may in some instances constitute a short sale or may otherwise result in liability for short swing profits. All executive officers and directors of the Company and such other identified persons must confer with the Insider Trading Compliance Officer before effecting any such transaction. The Company strongly discourages all such short-swings and short sale transactions by executive officers, directors and all employees.

While employees who are not executive officers and directors are not prohibited by law from engaging in short sales of the Company’s securities, the Company believes it is inappropriate for employees to engage in such transactions and therefore strongly discourages all employees from such activity. The Company has provided, or will provide, separate memoranda and other appropriate materials to its executive officers and directors and those identified employees regarding compliance with Section 16 and its related rules.

Source: Netflix Insider Trading Policy.
Available at: http://ir.netflix.com/documentdisplay.cfm?DocumentID=74. (October 6, 2010).