Executive Equity Ownership

Professor David F. Larcker
Center for Leadership Development & Research
Stanford Graduate School of Business
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In theory:

• Executives who hold equity in the companies they manage have greater incentive to build economic value.

• Equity ownership should discourage self-interested behavior.

• Actions that impair firm value would inflict corresponding damage to the executive’s personal wealth.

• As such, equity ownership is expected to mitigate agency problems.

This is the theory, but it bears closer scrutiny. What outcomes and behaviors are actually observed?
Equity Ownership by the CEO

- Executives hold considerable personal wealth in the companies they manage.
- Although some make direct purchases, most executive holdings come from compensation-related grants.

### CEO Equity Wealth Among U.S. Companies

<table>
<thead>
<tr>
<th>Market Value ($ thousands)</th>
<th>Total CEO Wealth ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 100</td>
<td>$36,577,000</td>
</tr>
<tr>
<td>101 to 500</td>
<td>6,928,000</td>
</tr>
<tr>
<td>501 to 1,000</td>
<td>2,057,000</td>
</tr>
<tr>
<td>1,001 to 2,000</td>
<td>639,000</td>
</tr>
<tr>
<td>2,001 to 3,000</td>
<td>175,000</td>
</tr>
<tr>
<td>3,001 to 4,000</td>
<td>35,000</td>
</tr>
<tr>
<td>1 to 4,000</td>
<td>332,000</td>
</tr>
</tbody>
</table>

Equity Ownership: Firm Performance

- There is extensive research on the relation between equity ownership and company performance.
- Modest evidence that equity ownership is correlated with higher market valuation.
- At the same time, some evidence that very large ownership positions (25 to 50 percent) lead to lower market valuation.
- Large ownership positions might allow for management entrenchment or misuse of firm assets for personal benefit.
- Unfortunately, researchers have not reached consensus. The board must use judgment in setting equity guidelines.

Morck, Shleifer, and Vishny (1988); McConnell and Servaes (1990); and Elsilä, Kallunki, and Nilsson (2009)
Target Ownership Plans

• A company might adopt a target ownership plan, which requires executives to hold a minimum amount of stock.

• Ownership guidelines can be expressed as:
  – Fixed number of shares
  – Multiple of annual compensation
  – “Retention approach” (executives are required to retain a percentage of exercised stock options)

• Researchers find positive benefits from the adoption of target ownership plans.

Core and Larcker (2002)

87% of the largest 250 U.S. companies have executive ownership guidelines.

Frederic W. Cook (2009)
Equity Ownership: Accounting Manipulation

• Is accounting manipulation more or less likely to occur in companies where executives hold large equity positions?

• The research on this topic is very mixed.
  – Some have found higher likelihood of restatement
  – Some have found lower likelihood of restatement
  – Some have found no association

• The board should be aware of the potential for self-gain through accounting manipulation.

• The potential for manipulation would seemingly be most pronounced when executives hold considerable amount of options.

Harris and Bromley (2007); Baber, Kang, Liang, and Zhu (2009); Armstrong, Jagolinzer, and Larcker (2010)
Manipulation of Equity Grants

- Equity ownership might encourage executives to manipulate equity grants to extract incremental value.

- Manipulate the timing of grants.
  - Delay grant date to occur after a stock price decline.
  - Bring grant forward to occur before expected rise.

- Manipulate the timing that information is released.
  - Delay the release of favorable information until after grant date.
  - Bring forward release of unfavorable information to precede grant date.

- In both cases, the executive seeks to maximize value by taking actions not in the interest of shareholders.
Manipulation of Equity Grants

- When equity awards are granted on a random basis, there is no discernable pattern in the stock price around the grant.
- A “V-shaped pattern” around the grant date suggests manipulation might be taking place.
- There is considerable evidence that this occurs.

Yermack (1997); Aboody and Kasznik (2000)

Manipulation of Equity Grants: Backdating

- Stock option backdating is the practice where insiders retroactively change the grant date to correspond with a relative low in the company share price.

- When practice was discovered in 2006, more than 120 companies were implicated. Abuses stemmed back to 1981.

- Stock option backdating largely stopped following Sarbanes Oxley, which requires that grants be reported in two days.

- Still, the practice violated GAAP, IRS tax rules, and SEC regulations and indicated a serious lapse in board oversight.

Equity Sales and Hedges

- Executives who accumulate a substantial ownership position in company stock might want to limit their exposure.

- The board of directors might allow diversification if it is in the interest of the company (i.e., by reducing risk aversion).

- Executives can achieve diversification by:
  1. Selling shares outright
  2. Hedging a portion through financial instruments
  3. Pledging a portion as collateral for a loan that is used to purchase additional assets
1. Trading by Insiders

- An insider is an individual—executive, director, employee, or advisor—who has access to material information about the company that has not yet been released to the public.
- Under SEC rules, insiders may only trade when they are not in possession of material nonpublic information.
- Trades on the basis of this information is considered illegal “insider trading”.
- Insider trading cases are prosecuted under Rule 10b-5, “Employment of Manipulative and Deceptive Practices.”
1. Trading by Insiders: Blackout Window

- To prevent executives from violating insider trading laws, companies designate a blackout window in which insiders are restricted from making trades.

- Blackout periods occur when material information (earnings, new product, acquisition) is not yet released to the public.

- The median length of a blackout window is 50 calendar days.

- Despite these restrictions, evidence suggests that insiders still have an information advantage in making trades.

  - Insider purchases precede periods of market outperformance.
  - Insider sales precede periods of market underperformance.
  - CEO and chairman have greater trading advantage than other insiders.

Seyhun (1986); Lakonishok and Lee (2001)
1. Trading by Insiders: 10b5-1 Plans

- The SEC created Rule 10b5-1 to protect insiders whose positions regularly expose them to inside information.
  - Insider enters contract with a third-party broker.
  - Insider must not know insider information at the time.
  - Insider specifies program by which trades (purchases or sales) are made.
  - Once in place, insider may not interfere with trades.
  - Broker executes trades, even during blackout window.
  - **However:** insider may amend or terminate at any time.

- Research evidence suggests that 10b5-1 plans are abused.

  - Insiders using 10b5-1 plans outperform market by 6% over six months.
  - Trades earned under plans are higher than trades made outside plans.
  - Sales precede periods of underperformance and purchases precede outperformance.

Jagolinzer (2009)
2. Hedging

- An executive might hedge the value of equity holdings rather than engage in outright sale of shares or options.
  - (+) Allows for diversification without an immediate sale
  - (+) Might be tax advantageous
  - (+) Minimizes public scrutiny that comes with outright sale
  - (-) Unwinds equity incentives to perform
  - (-) More costly to company than paying equivalent in cash
  - (-) Difficult to explain to shareholders why this is allowed

Hedges tend to follow periods in which the stock price has run up, and precede periods of underperformance.

Jagolinzer, Matsunaga, and Yeung (2007); Bettis, Bizjak, and Kalpathy (2010)
3. Pledging

• An executive might also pledge shares as collateral for a loan, the proceeds of which are used to purchase additional assets.
  – (+) Allows for diversification without lessening equity stake
  – (+) Might be tax advantageous
  – (+) Low interest rate on the loan
  – (-) Changes incentive structure imposed on management
    • What are implications if loan is called?
    • What if proceeds are used to launch new business?
    • Is the board willing to offset losses?

• Pledging transactions deserve special consideration by the board.
Repricing and Exchange Offers

- A repricing or exchange offer is a transaction in which employees holding options are allowed to exchange them for new options, restricted stock or (less frequently) cash.
  - (+) Generally all employees participate
  - (+) Provides new incentives when options are underwater
  - (+) Might improve employee retention and reduce turnover
  - (-) Might signal a culture of entitlement
  - (-) Investor relations challenge: shareholders wonder why employees benefit when shareholders are suffering losses

- Exchanges generally reduce employee turnover.
- Many firms (40%) that reprice exclude the CEO.
- Some evidence that repricings might be more likely to occur at companies with greater agency problems.

Carter and Lynch (2001); Chidambaram and Prabhala (2003); Change, Kumar, and Todd (2000)
Concluding Remarks

- Equity ownership is expected to provide positive incentive to executives to improve company performance.

- While the evidence suggests that equity can be successful in this regard, the board must consider negative consequences:
  - Executives might be encouraged to manipulate accounts.
  - Executives might manipulate timing of grants or public information to increase the value of their holdings.
  - Executives might rely on an information advantage relative to shareholders when buying, selling, or hedging.

The board should be very aware of this possibility and require procedures that minimize and discourage these outcomes.


