An Executive's Guide to Post-Vest Mandatory Holding Periods: What Does it All Mean?

Executives have faced a number of changes in their equity compensation with increasing regularity in recent years, and more are on the way. A series of federal laws and regulations have modified, innovated and reformed the way executives receive compensation. These corporate governance policy trends are being driven by shareholder advocates and proxy advisory firms interested in improving corporate governance and providing shareholders with more transparency.

An increasing focus on corporate governance has forced managements to view good governance as a part of the company's business strategy and objectives. The bar has been raised for aligning executive rewards to a long-term investment timeline. In their efforts to create a culture of performance with integrity, companies are defining or adopting stock ownership guidelines for executives.

While holding shares as part of executive compensation is not a new concept, there is growing interest by companies to require mandatory vesting holds on executive shares for an additional period of time, even after the executive leaves the company. The addition of post-vesting restrictions encourages executive retention while providing an incentive for long-term growth. At the same time, companies are recognizing the value of talent acquisition and retention, and are increasingly offering more shares to executives to compensate for the lack of liquidity given longer holding periods. As executive compensation trends continue to evolve, the goals remain the same: to align the incentives of the executives with those of shareholders.

Several of the proxy organizations have introduced company scorecards that rate the policies of public companies and rank them based on shareholder-friendly criteria. Companies can be penalized in the rankings for policies and compensation proposals deemed unfavorable to shareholders.

Proxy advisory groups prefer long-term holding by insiders and favor mandatory post-vest holding periods. In part, these policies clear the way for recouping compensation in the event of an accounting restatement (i.e., clawbacks). Mandatory post-vest holding requirements for vested equity awards provide one of the few practical mechanisms to recover incentive payouts in the event a clawback is triggered.

[1] Maximize Your Investment in Equity Compensation and be a Good Corporate Citizen at the Same Time, AON Valuation Services, Accessed March 1, 2016. https://www.radford.com/mandatory_holding_periods

More executive compensation awards are favoring the following:

1. Performance-based compensation vs. time-based compensation – more of the executive's equity compensation is tied to specific performance targets, such as revenue or profitability. These awards come in the form of Restricted Stock Awards (RSAs, RSUs) having performance or total shareholder return (TSR) requirements or Performance Stock Units (PSUs).
2. Longer holding periods for equity compensation awards and adding post-vest holding periods. Typically, these periods will prevent an employee from selling the underlying shares for a period of 1-2 years and occasionally even longer.

This paper is designed to assist executives in understanding and addressing the financial planning and tax implications of post-vesting holding periods.

Post-Vest Holding Periods Defined

Mandatory post-vest holding periods extend the period of time an executive must hold their own company shares. Many executives are now required to maintain minimum levels of stock ownership in their companies.

Mandatory holding periods typically prevent employees from selling vested equity until additional requirements are met— usually "owning" shares for one or two years – sometimes even longer --following the original vesting date.

There has been a rise in adoption of mandatory holding periods. A 2014 Cap study of Fortune 500 companies showed 64% require a 1-year post-vesting holding period.[2]

Insider executives must continue to monitor the company's blackout periods, which could further extend the period of illiquidity of equity awards. Companies are fairly consistent in defining the blackout periods in proximity to announcing their quarterly earnings numbers.

[2] Compensation Advisory Partners, *CAPflash newsletter,* Issue #63, (December 19, 2014)

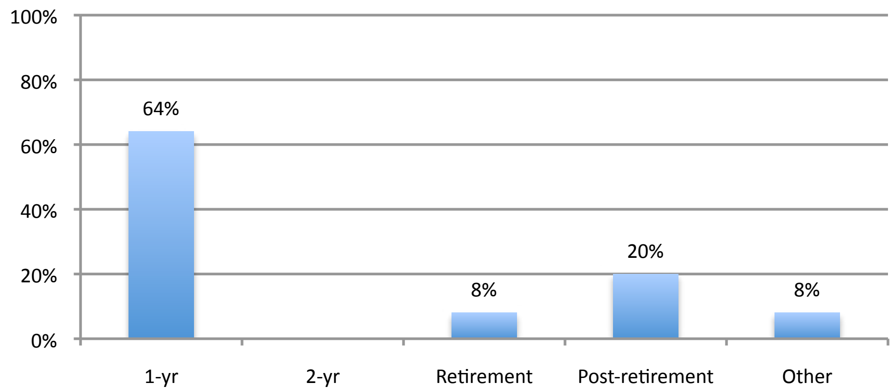
Length of General Retention Requirement

Survey Scope: 100 Fortune 500 companies across 9 industry groups

Based on CY 2014 Proxy Disclosures

Companies with stock retention requirements most often require executives to hold net shares from option exercises, restricted stock share/unit vesting or performance share payouts.[3]

Stand-alone stock retention requirements



Source: Compensation Advisory Partners, CAPflash newsletter, Issue #63, December 19, 2014

Benefits to Companies that Employ Mandatory Post-Vest Holding Periods

- **Shareholder interest alignment.** Mandatory holding periods demonstrate to shareholders an alignment between executives and the interests of shareholders.
- **Ownership target adherence.** When outlined in a company's stock ownership guidelines, mandatory post-vest holding enables executives to achieve ownership targets.
- **Tax status.** Post-vest holding can help executives improve their tax qualification status for other equity plans, such as Incentive Stock Options (ISOs) and Employee Stock Purchase Plans (ESPPs).
- **Reputation effect.** Companies that have mandatory holding requirements rank more favorably on scorecards used by proxy firms and compensation plan evaluators.
- **Clawback provision.** Mandatory post-vest holding allows companies to better enforce clawback provisions.
- **Valuation discount.** Companies may apply a discount for the lack of marketability (DLOM) to award valuations that can be used to reduce compensation expense.

[3] Compensation Advisory Partners, *CAPflash newsletter,* Issue #63, (December 19, 2014)

Compensation Trends for Executives as Mandatory Post-Vest Holding Takes Shape

Of significant interest, companies are starting to take into account how mandatory post-hold restrictions impact executives. "Because there is an accounting reduction that benefits companies," says Terry Adamson, partner and global practice leader at Aon Hewitt Equity Consulting Services, "increasingly companies are considering granting more shares to executives to counterbalance the additional restrictions."

For example, if a company wishes to grant $100,000 of value to a non-employee director when the stock price is $10, that would equal 10,000 shares. The accounting value would equal $85,000, assuming a 15% discount for a three-year mandatory holding period after vesting. Alternatively, if the board compensated for the illiquidity, they would need to grant the director 11,765 shares in order to have the full $100,000 accounting value.

Issuers can grant more shares to offset the restrictions of post-vest holding

Target Value Granted	$100,000	
Stock Value	$10.00	
Accounting Value	$8.50	
Approach	**Using Stock Value**	**Using Accounting Value**
Target Value Granted	$100,000	$100,000
Divisor	$10.00	$8.50
Shares Granted	10,000	11,765
Proxy Value (Accounting Value)	$85,000	$100,000

While there are meaningful trade-offs with mandatory post-vest holding requirements, today's public companies are adopting the compensation practice as part of good corporate governance.

Type of Compensation Awards

Responsible boards recognize the company will be rewarded for policies that extend the holding period on executive rewards and this is the desired result. The company may require the executive to retain a set number of shares following the exercise or vesting of other equity-based awards. Types of equity compensation subject to mandatory holding periods include[4]:

- Restricted Stock Units or performance awards tied to company stock may be subject to forced deferral of payout post-vest;
- ESPP shares qualified may be subject to required holding;
- Options are usually not subject to post-vest holding, as it would be tied to the shares post-exercise (not post-vest);

[4] Post Vest Holding Periods: The Intersection of Corporate Governance, Plan Design, and Financial Accounting, NASPP Connecticut webcast, (February 2015)

The most widely used metrics to determine PSU vesting (regardless of the hold requirements) are Total Shareholder Return (TSR) which come in two flavors, Absolute TSR (meaning the metric is specific to the company itself; e.g., the stock price plus dividends need to increase by 8% per year over a three-year period in order for vesting to occur) and Relative TSR (meaning the metric considers the share price/dividend performance of similar companies; e.g., Pfizer needs to increase by 8% if Abbot increases by 8%).

Tax Implications by Equity Award Type

Options. Options are normally time-based awards. You owe taxes on the value at exercise. You cannot defer the taxable event beyond the date of exercise. And, if the option award is subject to a post-vest holding period, you can't sell the shares you exercised right away. Thus, you could be subject to market risk during the post-vest holding period, making for a number of accounting challenges.

Performance Stock Units. These present a liquidity challenge as well. The vesting date is typically a trigger for a taxable event. With the exception of making a short-term deferral election, you cannot defer the taxable event beyond vesting. If you cannot sell the after-tax net number of shares available, you could be subject to market risk during the post-vest holding period.

Restricted Stock Units. Under the Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA), there is no way to avoid withholding of employment taxes at vest; however, you are not subject to income tax until the award is released. You are customarily subject to income tax simultaneous upon vesting; consequently, the post-vest holding period does not alter the timing of income tax liability. (See allowance for narrow exception at the end of this section on taxation.)

Most companies have allowed for the payment of withholding taxes on RSUs. They would typically free a portion of the shares for sale (Sale to Cover) or withhold shares (Withhold to Cover) to fund the payment of taxes for the tax year in which the shares vest.

Performance Stock Units (PSUs) trigger FICA/FUTA tax liability when they vest and ordinary income tax, the larger financial outlay, when the shares are released. Similar to RSUs, the post-vest holding period most likely would not significantly alter the timing of tax liability.

Narrow exception. IRS Code 409A allows for a short-term deferral of share release. You may have the option to defer your receipt of shares under your plan's document for up to two and one-half months following the end of the participant's tax year.

Note on the company withholding: upon vesting, many companies will withhold tax on performance shares from other cash bonus awards.

Effect of Holding Period on Retirement or Termination

Executives are held to post-vest holding restrictions whether or not they leave the company. Most companies mandate that all vested options be exercised within a period that typically ranges from 30-90 days, with flexibility on vesting and exercise for retirement-eligible executives. The retirement-eligible threshold of age 55 is commonly built into pension and stock-based compensation programs. After the executive passes the retirement-eligible age threshold, their stock grants may continue to vest; however, they would still be subject to the post-vesting holding period. This has many executives thinking through the implications of this and what resources they may need in retirement to ride out the holding period without access to these shares.

Even if an executive resigns from the company, the executive is still subject to the post-vesting holding period. If not, company executives might be incented to “take the money and run.” If you leave voluntarily or involuntarily, you wouldn’t lose what’s been granted, but you would be subject to the same post-vest holding period.

Executive Planning Implications

It is important to realize the distinction between wealth and liquidity. Even though the liquidity issue can be a burden, many executives have a sufficient level of assets in a variety of accounts to meet their goals. The timing issue is particularly challenging for retiring executives who may be counting on company stock to fulfill short-term financial needs. In this case, the challenge is to identify a bridge from the intended retirement date to the end of post-vest holding periods.

In the wake of extended post-vest holding periods, you need an understanding of the rules governing all your equity compensation, tax implications and liquidity. There are penalties for tapping IRAs and these pensions prematurely, which should be avoided.

Just as we ladder a strategy for bonds and other assets coming due, we can band a similar timeline for compensation that may be coming available.

Timing Analysis of Executive Awards

As equity professionals with backgrounds in financial planning, tax and executive compensation, we work with executives to address the income gap created by post-vesting holding periods. They are often approaching a financial planning milestone, such as retirement or college funding for their children.

As we work with executives on the liquidity impact of their executive compensation, we take into account all the financial resources they have available. It is important to factor in the dates when various equity awards can be sold. We would band different awards together and set up laddered income strategy using all sources of income and compensation to estimate the retirement income stream.

Our process includes the following steps:

1. Plot the resources/expenses for each year to determine the quality of income stream for five or more years
2. Integrate the timing of funds available, taking into account when shares clear the post-vesting period
3. Plan to access on date certain, the retired executive's 401(k) and IRA accounts, as well as Social Security, which could be years in the future.
4. Maximize the lifetime considerations for use of retirement plan accounts, Social Security and IRAs
5. Combine these variables in an income source matrix that will provide the roadmap for the specified goal (e.g., retirement, college funding, or other goal).

Changes in executive compensation policy can have a profound effect on the financial plan, including the timing of payments, taxation, personal retirement timeline and potential market risk. While the executive may not be able to impact executive compensation policy and trends, the best defense is a good offense. Being prepared with a well-conceived financial plan will ensure that the executive has a firm grip on the controls and prepares for the future with confidence.

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