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Managerial shareholding policies and retention of vested equity incentives[☆]

Piotr Korczak *, Xicheng Liu

School of Economics, Finance and Management, University of Bristol, 8 Woodland Road, Bristol BS8 1TN, UK

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ABSTRACT

Previous literature documents that executives tend to cash out equity incentives when equity-linked compensation vests. Such a behavior destroys long-term incentives and hence is costly to outside shareholders. It is recommended that the unloading of incentives can be limited when the firm adopts a minimum executive shareholding policy. We provide the first evidence of the effectiveness of such policies in that respect. Using data for UK FTSE 350 companies we show that executives whose ownership is below the minimum set by the policy retain more newly vesting equity and the incentives to retain shares weaken when the holdings are above the minimum. We also document economic implications of compliance with the policy and we find higher firm valuations when actual ownership increases relative to the minimum holdings required. Our results have implications for the debate on executive remuneration regulations and practices.

1. Introduction

To align the interests of managers and shareholders and to give managers 'skin in the game', companies are recommended to move towards compensation schemes with a larger equity-based component (e.g., Greenbury, 1995).[1] Theoretical underpinnings of the recommendation go back to the seminal work by Jensen and Meckling (1976), who show that managers with larger holdings are more likely to act in outside shareholders' interest and undertake value-increasing actions rather than opportunistically extract private benefits. Equity-based compensation is effectively expected to increase managerial equity holdings.[2]

Does the equity-based pay indeed succeed in increasing managerial equity exposure? Ofek and Yermack (2000) provide striking evidence that the answer is no. They show that managers hedge their exposure by selling shares already held in response to new option and stock grants, and they also sell almost all shares acquired from exercised options. The result casts doubt on actual incentives created by equity-linked pay, and as noted by Jensen et al. (2004) 'we have been mystified for many years as to

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* Corresponding author. Tel.: +44 117 9288407.
E-mail addresses: P.Korczak@bristol.ac.uk (P. Korczak), Xicheng.Liu@bristol.ac.uk (X. Liu).

[1] In line with the recommendations, the structure of executive remuneration has been moving towards a greater importance of equity-based components. For example, the value of option and share awards accounted for 26% of the average total US CEO compensation in the 1980s, 47% of the total compensation in the 1990s and as much as 60% of the total compensation after 2000 (Frydman and Jenter, 2010). In 1997, 72% of CEOs in the USA and 50% in the UK were awarded options, and 19% and 32% of CEOs in the two countries, respectively, were granted long-term incentive plan (LTIP) shares (Conyon and Murphy, 2000). As of 2006 the equity-based element became a significant part of total compensation worldwide (Fernandes et al., 2011).

[2] For example, the Greenbury Report (Greenbury, 2005), the world's first corporate governance code to look specifically at executive compensation, explicitly says that share option schemes 'enable directors to build up holdings of shares in the company' (point 6.27, p. 40) and that LTIP share schemes encourage executives 'to build up shareholdings in their companies' (point 6.34, p. 42).

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why boards do not formally restrict managers' freedom to unwind the incentives the remuneration committee constructs for them' (p. 67). Ofek and Yermack (2000) suggest that to limit the unwinding of equity-linked incentives, firms could adopt minimum shareholding policies for executives. In this paper we provide the first test of whether such policies prevent executives from the unloading of equity incentives.

Our particular focus is on the retention of shares acquired from exercised options and from vested LTIP share schemes. Once equity-linked compensation vests, executives generally have freedom to sell the newly acquired shares and hence cash out equity incentives. Such a behavior is costly to shareholders (Bebchuk and Fried, 2004, 2010; Holmstrom and Kaplan, 2003). First, to maintain the desired equity exposure of executives, it requires further equity-linked incentives to be granted to replace the incentives cashed out. Those further grants in turn dilute outside shareholders' ownership and claims on the firm. Second, and more important, the unloading of shares shortly after vesting and exercising leads to a focus on short-term stock prices, and executives who plan to cash out equity incentives look for ways to boost the stock price over the short run even at the expense of long-term value creation. For example, it is documented that managers are likely to reduce real investment when the amount of newly vesting equity increases because the effects of the investment are usually visible in the long run while the investment reduces earnings and cash flows over the short horizon (Edmans et al., 2013; Ladika and Sautner, 2013). It is also found that managers manipulate reported earnings to increase the share price at the time when they exercise stock options to maximize the proceeds from cashing out (Bartov and Mohanram, 2004; Bergstresser and Philippon, 2006). The short-termism caused by remuneration practices has been widely blamed for significantly contributing to the recent financial crisis.[3]

There are proposals and recommendations coming from both academics and policy-makers to address the problem of the unwinding of equity incentives (e.g., Bebchuk and Fried, 2004, 2010; Bebchuk et al., 2010; Holmstrom and Kaplan, 2003; Jensen et al., 2004). For example, Bebchuk and Fried (2010) argue that the key principle in restoring long-term incentives is to require executives to hold a large percentage of equity-linked incentives after they vest. In their Principle 1 they propose that 'executives should not be free to unload restricted stock and options as soon as they vest, except to the extent necessary to cover any taxes arising from vesting' (p. 9). In a similar vein, the Greenbury Report and all subsequent corporate governance codes in the UK recommend[4]that 'directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities' (Greenbury, 1995, point 6.34, p. 42).

The statement by the US treasury secretary, Tim Geithner, on compensation from June 2009 calls for compensation practices that are aligned with the long-term value of the firm and recommends that 'asking executives to hold stock for a longer period of time may be the most effective means of doing this'.[5] Similarly in the UK, the Walker Report (Walker, 2009) that looks at corporate governance in financial institutions amid the recent financial crisis recommends that executives 'should be expected to maintain a shareholding or retain a portion of vested awards' (Recommendation 34, p. 118). Holmstrom and Kaplan (2003) argue that the benefit of improved incentives when executives are restricted in selling shares after exercising options outweigh the costs of the lack of diversification of managerial portfolios.[6]Ofek and Yermack (2000) suggest that a minimum managerial holding policy could be a specific mechanism put in place by the board to address the problem of the unloading of equity incentives.

Over the years, minimum shareholding policies have gained increasing popularity. Core and Larcker (2002) provide early evidence from the USA and find a growing number of adopters between 1991, when the first US firms adopted the policy, and 1994. According to a report by a consulting firm Frederick W. Cook & Co, in 2009, 87% of the 250 largest US corporations had formal stock-ownership guidelines for executives.[7] Similarly, there are a rising number of UK firms that adopt minimum holding policies. In the group of FTSE 350 firms analyzed in this paper, we find that as few as 12 had the policy in place in 2000, and the number rose to 172 in 2009. Core and Larcker (2002) find that the probability of policy adoption is driven by low executive shareholding and weak stock performance. They also show that ownership rises after the adoption of the minimum holding policy. However, Core and Larcker (2002) do not explicitly investigate the effectiveness of minimum holding policies in addressing the problem of the unloading of equity incentives acquired from share-based compensation schemes.[8] This leaves an important, yet untouched, question in the literature: how effective are the minimum holding policies in preventing executives from cashing out shares acquired from equity-linked compensation? This study attempts to answer this question.

Our main variable of interest is defined as the annual change in the number of shares held by the executive divided by the sum of exercised options and vested LTIP shares over the year. We find that the median executive in the sample adds 47 shares to their holdings for every 100 newly acquired shares, indicating that more than a half of the shares are cashed out. In a set of regressions

[3] For example, the US treasury secretary, Tim Geithner, in his statement on executive compensation said that 'this financial crisis had many significant causes, but executive compensation practices were a contributing factor. Incentives for short-term gains overwhelmed the checks and balances meant to mitigate against the risk of excess leverage' (http://www.treasury.gov/press-center/press-releases/Pages/tg163.aspx).

[4] Corporate governance codes operate in the UK as codes of good practice and they are based on the 'comply or explain' principle. The compliance is not mandatory but it is based on full disclosure, and firms that do not comply have to explain their non-compliance (see, e.g., MacNeil and Li, 2006).

[5] http://www.treasury.gov/press-center/press-releases/Pages/tg163.aspx.

[6] Executives have a large portion of personal wealth that is tied to the company that they serve, in terms of both human capital (e.g., Mehran, 1995) and shareholdings. According to the portfolio-diversification view, they sell shares already held in response to new equity-linked incentives to diversify their personal wealth in the company. Grout and Zalewska (2012) identify conditions under which there is complementarity between option and stock holdings, in contrast with the traditional view of substitutability that leads to the demand for diversification.

[7] http://www.fwcook.com/alert_letters/Stock-Ownership-Guidelines-Report-10-23-09.pdf.

[8] The sample period analyzed by Core and Larcker (2002) coincides with the period of great popularity of loans companies made to executives, for example, to finance stock purchases. Bebchuk and Fried (2003) report that 75% of the 1500 largest US corporations made loans to their executives in the 1990s, and Kahle and Shastri (2004) find that loans to finance stock purchases were particularly given to managers with low stock ownership. The Sarbanes–Oxley Act of 2002 prohibited executive loans in the USA. In the UK they were prohibited much earlier by the Company Act of 1985.