

Frederic W. Cook & Co., Inc.

New York • Chicago • Los Angeles

7/25/02

**THE “RETENTION RATIO” OWNERSHIP GUIDELINE**

There is a growing perception that corporate executives often profit from inside information by selling all or a portion of the equity stakes in their companies prior to a significant decline in share price. To protect against this perceived abuse, politicians and corporate governance advocates alike are calling for requirements that executives hold all, or substantially all, shares received from company stock plans for the duration of their careers.

Most companies with stock ownership guidelines express them as a multiple of salary that must be achieved over a five-year period. For example, a CEO with a \$1 million salary and an ownership guideline of five times salary is expected to own company shares with a value at least equal to \$5 million. If stock price falls, the CEO would be expected to acquire more shares to bring the value of his or her holdings up to \$5 million. Conversely, if stock price rises, presumably the CEO is free to sell shares representing the value above \$5 million.

In the rising market of the 1990s, it was relatively easy for most executives covered by multiple-of-salary ownership guidelines to accumulate an ownership position through stock options well in excess of the guideline amount. And because of the implied ability of executives to sell shares they receive above the guideline amount, the potential for short-term profit maximization through insider stock sales still exists. Another drawback of this ownership approach is that, in the flat to down market of recent times, it is very difficult to meet multiple-of-salary guideline amounts over the typical period of five years.

A less common type of ownership guideline that avoids the problems inherent in multiple-of-salary guidelines is the “retention ratio” approach. Under this approach, whenever an executive receives shares from company stock plans, such as when a stock option is exercised or shares are received as payment under a long-term incentive award, a portion of the net gain shares (i.e., those shares remaining after payment of the option’s exercise price and income taxes owed) must be retained for the balance of the executive’s career with the company. With a retention ratio, shares owned always increase; they never decline during active employment. In addition, the value of the share holdings is unimportant, and there is no need to reach a guideline amount within a specified timeframe, which minimizes the possibility that executives will view the guideline as a financial burden.

This is not to say that retention ratio ownership guidelines are without design issues of their own. The primary criticism of the retention ratio is that, since shares cannot be sold during active employment, executives are forced to leave their companies if they see stock price dropping and want to protect or diversify their investment portfolios. We believe this issue can be addressed. Areas of design flexibility in the retention ratio approach that can be tailored to a particular company’s situation include the following:

- Tiering of the ratio (e.g., from 75% at the top executive level to 25% at the lowest covered management level)
- Imposing a threshold ownership value, without a specified time period for achieving it, and reducing the ratio once it is achieved
  - For example, a CEO might have a 100% retention ratio until a three times salary multiple is achieved, with a 50% retention ratio thereafter
- Making net gain shares subject to retention for a specified period (e.g., five years) and then permitting the shares to be sold
- Scaling back, but not totally eliminating, the ratio upon becoming eligible for early retirement (e.g., age 55 with ten year's service)
- Extending the ownership requirement to six months or one year following termination
- Coupling permitted sales of shares with a structured diversification plan under SEC Rule 10b5-1

While stock options and other company stock grants or payments are important elements of any competitive and balanced total compensation program for executives, they also have a long-term ownership objective. Requiring executives to maintain an ownership position in their companies' equity is reasonable. We believe the advantages of the retention ratio make it more attractive than the multiple-of-salary approach for structuring stock ownership guidelines.

\* \* \* \* \*

This letter is intended to alert compensation professionals about developments that may affect their companies. General questions may be addressed to Wendy Hilburn in our New York office at (212) 986-6330 or by email at [wjhilburn@fwcook.com](mailto:wjhilburn@fwcook.com). This letter and other published materials are available on our website, [www.fwcook.com](http://www.fwcook.com).