

AGENDA

Merrill Requires Director Stock Ownership

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News Analysis by Agenda Author

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With scrutiny of directors ever increasing, more companies are reevaluating director stock ownership requirements. Merrill Lynch has adopted guidelines for its directors, while other companies, including LaidLaw International, are raising the bar concerning how much stock directors must own.

Such guidelines may be good for shareholder optics, but some experts question what purpose they serve beyond shoring up a company's governance image. Indeed, not all companies are moving toward more stringent requirements. Lam Research, for one, has cut the number of shares it requires directors to own by a quarter.

These moves come as companies are taking a closer look at their stock ownership guidelines for executives (see story on opposite page). Guidelines for executives ensure that a large portion of their compensation remains at risk after rewards are earned. As with many trends in executive compensation, companies want the same situation for directors.

Merrill Lynch explains in its last proxy statement that "the equity component of director compensation serves to further align the non-management Directors with the interests of our shareholders." The company established its guidelines for directors last year. It requires that directors own stock worth at least \$375,000 — five times the annual cash retainer of \$75,000. Directors have five years to meet this requirement.

Beating Merrill to the punch, General Motors announced for the first time in last year's proxy statement that it had adopted the same guidelines: five times the annual retainer after five years.

LaidLaw International, a holding company that counts Greyhound Lines among its operations, amended its stock ownership guidelines to require that directors own stock valued at five times the annual cash retainer of \$47,500. That's up from three times the retainer for all directors except the chairman, who had previously been required to own five times.

These moves reflect dominant trends in executive compensation. The most common method of establishing stock ownership guidelines for CEOs at S&P 500 companies has been to use a multiple of five times annual salary, according to Equilar's research.

While it makes sense to require that directors own company stock, experts doubt that it has the same effect on directors as it does on executives. Directors are not on the board necessarily for the sake of their livelihoods. And there is a potential problem once directors accumulate and hold a large amount of company stock. If the value of the shares held by directors reaches a high level, "are they really independent?" asks Bob Romanchek, comp consultant with Hewitt Associates. "There needs to be a balance."

That balance could come in the form of less stringent stock ownership guidelines for directors.

Lam Research, which manufactures equipment for semiconductors, actually reduced significantly the amount of stock it requires directors to own. It cut the requirement this year from 20,000 shares of common stock or vested options to 5,000 shares.

Sprint Nextel, in this year's proxy statement — its first since the merger of Sprint and Nextel — disclosed that it requires directors to own two times the annual retainer of \$70,000. Directors have two years to meet this requirement. Prior to the merger, Sprint had required that directors own five times the annual retainer.

One way to accomplish the desired end of director stock ownership without imposing guidelines is to add vesting restrictions to the stock directors receive. J.C. Penney does not have formal ownership guidelines, but grants "are restricted until the director's service on the Board ends," states a Form 8-K filed by the company in May.

This ensures that directors have skin in the game as long as they remain on the board. Michael Kesner of Deloitte Consulting says that companies can accomplish this by just restricting equity until directors complete the year of service for which they received the grant. This way, he says, companies receive "one year of service for one year's worth of equity."

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