

Why Small-Cap Boards Should Adopt Stock Ownership Guidelines

By Adam J. Epstein



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The vast majority of large, public companies have stock ownership guidelines (SOGs) that require non-employee board members to attain a certain level of stock ownership within a defined time period and maintain that ownership over the course of their tenures. The number of smaller public companies with SOGs for directors is comparatively small, but growing fast. Small-caps should get ahead of this curve.

According to Fenwick & West LLP's recently released report *Corporate Governance Practices and Trends: A Comparison of Large Public Companies and Silicon Valley Companies*, 91 percent of companies in the S&P 100 have SOGs for directors.

Looking at the 150 largest Silicon Valley companies, those at the bottom of that list that have SOGs for directors is much lower—32 percent—but that's quickly changing. According to Fenwick's data, none of these small-cap companies (with average market capitalizations of around \$1 billion) had SOGs for directors as recently as 2006. For comparison, nearly 70 percent of S&P 500 companies had SOGs for directors in 2006.

Investors are keen on SOGs because they feel that when insiders have some skin in the game, it's more likely that their interests will be better aligned with shareholders (i.e., they will have more

incentive to focus on long-term value creation).

SOGs might require non-executive board members to own some multiple of their annual cash retainers in stock. Such guidelines typically provide a time period (e.g., five years) for board members to comply, and most have hardship exemptions that are reviewed on a case-by-case basis.

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Small-caps that don't yet have SOGs for board members or officers should consider a variety of issues.

Activism. Notwithstanding the media's focus on activist campaigns in companies like DuPont and Procter & Gamble, the preponderance of shareholder activism happens in small-cap companies. In this ecosystem, a common issue raised by activists is that many small-cap board members are not shareholders.

Nails on a chalkboard. Officers and directors often make the mistake of pointing to their stock options as evidence of having skin in the game. It's hard to understate

how maddening this argument is to institutional investors. From a buy-side perspective, stock options do not constitute skin in the game; stock purchased with cash, however, does. If your board is going to implement SOGs, make sure insiders are required to buy some portion thereof with cash. After all, there is only one way investors can acquire your company's shares, and that's with cash.

When in doubt, ask your investors. Many small-cap fund managers are more focused on whether or not a company has SOGs versus the prescribed ownership thresholds. Rather than get mired in expensive, potentially conflicting advice from consultants, proxy advisors, and lawyers, small-cap companies should simply discuss SOGs with their largest investors, and be guided by their thoughts and expectations.

Small-cap companies without SOGs should be prepared to answer one austere question from savvy investors. "Presumably, your company's board members know far more about the company than investors do. If they're not willing to buy and hold some multiple of their annual compensation in stock, why should we?"

Since there's no compelling answer to that question, small-cap companies without SOGs should implement them sooner as opposed to later.