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Diversification Strategies for Public Company Executives



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Wealth creation for public company C-suite executives is bound inextricably to their company's stock price—and for good reason: making share price returns a critical driver of executive compensation is a way for corporate boards and shareholders to align management's focus with company performance. The downside, though, is that this linkage can lead to executives' investment portfolios becoming concentrated in a single stock. As a consequence, executives' income (through their employment) and net worth (via their equity holdings) can face material idiosyncratic risk.

Traditional diversification strategies, typically, are not well suited to the circumstances of corporate executives. Firstly, share sales by corporate executives can only be made during "open-window" periods—usually for four to six weeks after each quarterly earnings release. Even during those times, material nonpublic information provisions may prohibit them from transacting company stock. Additionally, company-specific agreements may further limit executive stock sales, spelling out the number of shares that can be sold in a given period and imposing certain stock ownership requirements. Finally, most companies restrict executives' use of derivatives, ruling out the potential for executives to hedge their equity holdings.

Even without such restrictions, corporate executives are likely to be concerned with the optics surrounding their stock sales, wishing to present a bullish stance. Furthermore, executives may face pressure from boards to hold onto their shares, given the message sent by reducing their equity holdings in the pursuit of portfolio diversification.

Given the limited options for diversification available to C-suite executives, we offer some solutions for consideration, starting with more straightforward strategies and concluding with more complex ones. Even if executives do encounter strict constraints, there may be value in exploring potential options on an annual basis.

This paper seeks to address strategies for those corporate executives with restricted equity positions. For those with concentrated but unrestricted equity positions, please consider the 2022 Investment Primer: [“Managing a Concentrated Position.”](#)

In Exhibit 1 below, we share an overview of these potential options, followed by a more detailed treatment in the section on each option that follows.

Exhibit 1. Corporate Executives May Benefit from Reviewing Potential Diversification Strategies on an Annual Basis

Potential Option	Description and Considerations
 Counterbalancing Portfolio Allocation	Removing company and industry exposure from non-company assets. Not applicable for executives who have few assets outside of company equity.
 10b5-1 Plans	Trading plans for insiders. Plans must be subject to company agreement and insiders should be aware of new amendments to Rule 10b5-1.
 Exchange Funds	A limited partnership in which investors can swap shares of their concentrated position for a basket of diversified shares.
 Estate Planning	Transferring company equity to family members or separating assets into trusts. Insiders should be cognizant of recent SEC amendment requirements prior to gifting.
 Charitable Gifting	Gifting company equity to charity. Insiders should be cognizant of recent SEC amendment requirements prior to gifting.
 Leveraging Public Market Liquidity	A transaction arranged away from the public markets that may offer liquidity for those with thinly traded shares.
 Pledging Corporate Stock	Using company shares as a collateral for a loan. May be appropriate for executives with a higher risk tolerance.

Source: Morgan Stanley Wealth Management Global Investment Office (GIO)

Counterbalancing Portfolio Allocations

Corporate executives often counterbalance their portfolio's other holdings against their corporate stock holdings as a way to diversify. This strategy seeks to limit company and industry exposures in portfolio holdings apart from the corporate equity holdings. If restricted equity positions make up a substantial portion of a corporate executive's portfolio, however, counterbalancing efforts face inherent limitations.

Direct indexing strategies may prove effective in executing a counterbalancing approach. These strategies, implemented through separately managed accounts, typically seek to replicate established equity indexes via direct ownership of underlying constituents, while aiming to generate tax losses to offset gains in the account and the broader portfolio. Direct ownership allows for customization, so that a company executive could require that the portfolio avoid exposure to the company stock or sector. For an executive with shares that have appreciated greatly over time, the direct indexing strategy's accrued tax losses may be useful later when conducting sales of company stock. For a more in-depth overview of direct indexing, we recommend the special report [“Direct Indexing: Opportunities for Customization and Potential Tax Alpha.”](#)

Depending on circumstances and preferences, direct indexing may be needed to counterbalance exposure to the company share price—and may even extend to avoid equities altogether in their other assets. In structuring counterbalancing positions, investors should weigh multiple factors, including the relative weights of corporate equity and other assets; expected volatility contribution of their corporate equity positions; risk tolerance; and target asset allocation, among others.

10b5-1 Plans

Securities and Exchange Commission (SEC) Rule 10b5-1 allows company insiders to establish preset trading plans for shares they own. The rule offers many advantages, including protection against accusations of insider trading and the ability to trade during blackout periods. While still subject to their company stock agreements, 10b5-1 plans allow insiders to choose how often and how many shares to sell, as well as specifying price targets at which to sell.

Although 10b5-1 trading plans offer many benefits, the SEC recently amended the rule to place further restrictions on their use. The new requirements include a mandatory 90-day “cooling-off” period, measured from a plan's execution to the potential start of any trades, and the restrictions on multiple, overlapping plans and single-trade plans.

Additionally, the SEC adopted new disclosure requirements, expanding requirements for issuers and mandating quarterly disclosures as to whether the director or officer has adopted, modified or terminated a plan and a description of the terms of each plan. It is too early to tell what impact these new requirements will have on 10b5-1 plans. Regardless, these plans are likely to continue to provide valuable diversification benefits.

Exchange Funds

Exchange funds may offer a compelling strategy for those with highly appreciated shares. Structured as limited partnerships, exchange funds allow investors with concentrated positions to swap them for a diversified stock portfolio, typically over a seven-year holding period. To accomplish the tax-deferred nature of the exchange fund, its managers usually allocate a portion to real estate. Initial contributions to an exchange fund do not trigger tax consequences, allowing the swap into a diversified equity portfolio without an initial tax bill. Exchange funds provide the opportunity for tax-deferred growth, as investors will not bear tax liability until they sell the resulting shareholdings. Upon liquidation, the exchange fund's units receive the aggregate cost basis of the total shares initially contributed.

Despite these benefits, exchange funds are not without drawbacks. Because exchange funds involve transferring shares, they may not be permissible within an executive's company stock agreement. Even if their use is allowed, there may be limits on the total number of shares an executive may contribute to the structure. Furthermore, given the constraint of their seven-year lockup period, exchange funds may not be appropriate for those seeking immediate liquidity. Finally, there are limitations on the types and sizes of the positions exchange funds will accept. Some only accept holdings of well-established companies with large market capitalizations. In addition, funds have minimum (and maximum) investment requirements; as such, exchange funds may only satisfy a small part of executives' diversification strategies.

In sum, exchange funds may offer a tax-efficient diversification solution, but certain factors may limit their usefulness, especially provisions in an executive's company stock agreement, exchange funds' seven-year "lock-up" and acceptance policies.

Estate Planning

Corporate directors and insiders may find greater flexibility within insider trading policies when exploring legacy planning strategies. While bona fide gifts to family members is technically not a sale or purchase of securities, recent SEC commentary hints that gifts may face greater scrutiny than under previous rules interpretations.

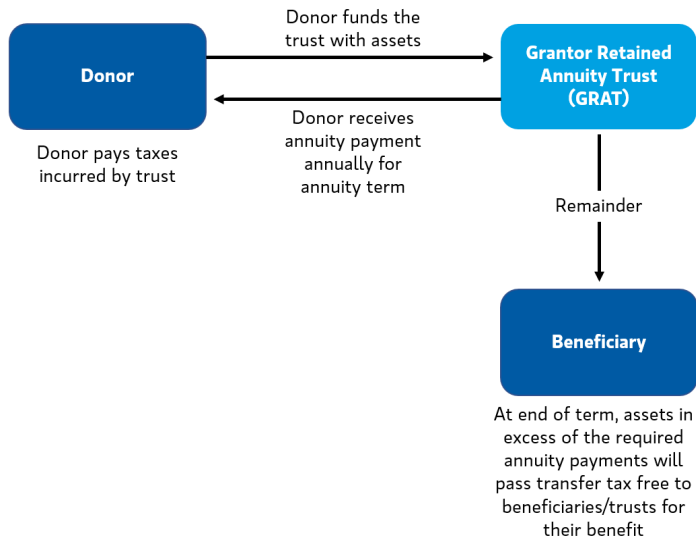
The SEC's latest amendment affects not just 10b5-1 plans, but also bona fide gifts. The SEC has clarified that gifts may be subject to scrutiny for insider trading enforcement and that the affirmative defense under Rule 10b5-1 is available for planned securities gifts¹. Some legal practitioners have argued that an insider can gift securities at any time because a gift involves neither a purchase nor a sale, but the SEC's latest clarification suggests that insiders should refrain from making gifts when in possession of material non-public information. Finally, bona fide gifts of securities that were previously permitted to be reported on Form 5 will be required to be reported on Form 4 within days, whereas previous guidelines required such reporting only within 45 days after the end of a company's fiscal year. Insiders should obtain pre-clearance from their compliance officer prior to implementing any estate-planning strategies.

The most straightforward type of gift, an outright gift, transfers shares out of the estate. Depending on the identity of the recipient, outright gifts may be subject to insider trading rules. Executives may also consider gifting company shares to trusts outside of their taxable estate rather than making a gift directly to individuals.

Corporate executives commonly utilize a grantor retained annuity trust (GRAT), which allows a donor to transfer assets to a trust and then receive those assets, plus interest, via annuity payments over time. The benefit of such a structure is that any trust assets that remain flow to the trust's beneficiaries free of estate and gift taxes. The structure fits well with volatile underlying investments, as the volatility increases the potential of large estate tax-free gift.

In many cases, the agreements for such a trust specify the annuity payment as an "in-kind" distribution. Under that arrangement, the trust transfers shares placed in the GRAT directly back to grantor rather than through a cash payment, thus averting the need to sell any shares during the trust term. Taken together, GRATs can be an effective legacy planning strategy for executives expecting significant price appreciation in their company stock.

Exhibit 2. Grantor Retained Annuity Trusts Represent a Potentially Effective Estate-Planning Strategy for C-Suite Executives



Source: Morgan Stanley Wealth Management GIO

Charitable Gifting

Philanthropically inclined corporate directors and insiders may enjoy greater leeway with gifts to non-profits. But while gifts to charitable organizations present better “optics,” investors still await further clarity on the SEC’s deliberation on bona fide gifts.

Importantly, donors receive tax deductions related to charitable gifts, making appreciated shares an attractive giving option. For publicly traded shares and restricted shares gifted to Donor Advised Funds and other public charities, the fair market value of the shares is deductible up to 30% of the donor’s adjusted gross income (AGI). For publicly traded shares gifted to private foundations, the AGI deduction limit drops to 20%. For restricted stock and private company shares gifted to private foundations, only the basis may be deducted, implying that donors may wish to consider a public charity instead for such shares.

A recent study, entitled “Insider Giving”² from the *Duke Law Journal*, argues insiders have historically taken advantage of lax regulations by donating and deducting the value of their shares, while holding material non-public information presaging lower share prices in the future. The recent SEC amendments may have been adopted, in part, in response to those allegations, suggesting charitable giving may increasingly come under the microscope in coming years. As such, corporate insiders might consider these options: 1) incorporating charitable giving in their 10b5-1 plans; 2) giving only during open trading windows; 3) clearing any philanthropic gifts with their corporate counsel; and 4)

planning their charitable giving well before year-end.

For both estate planning and charitable gifting decisions, we recommend that clients consult with appropriate legal and tax counsel. Any guidance remains highly customized and situation-specific, lying outside the scope of this overview.

Leveraging Public Market Liquidity

When considering liquidity options, those holding thinly traded shares may look to block trades or direct sales to institutional buyers. Block trades, which are arranged outside the public markets, are designed to dampen any price impact from large sales. The buyer—typically a brokerage house—breaks up the block into many smaller orders and may use dark pools (private exchanges where large buy and sell orders can be matched out of public view). Alternatively, the broker could find an institutional buyer willing to privately purchase all the shares at a discounted price. Both block trades and institutional buyer-led transactions would be subject to company stock agreements and prevailing securities law. Nonetheless, these options may be appropriate, in certain circumstances, for trades that represent a high fraction of the public float.

Pledging Corporate Stock

Share-pledging, while holding material risk, offers insiders another means of accessing liquidity. Share-pledging involves using shares in company stock as loan collateral. The insider then uses the proceeds to cover liquidity needs or invest in a diversified portfolio.

As a downside, this strategy involves leverage and increases portfolio-level risk. Should the pledged stock’s share price drop considerably, the investor could face a margin call, in which case, she would be required to either sell shares, pledge additional shares or deliver sufficient cash to either satisfy any margin balance or reduce the loan size. Forced sales could prove especially problematic for insiders who may face contractual prohibitions against these sales.

For this reason, some companies do not allow insiders to pledge their company shares. Institutional Shareholder Services (ISS) research suggests that 68% of S&P 500 companies ban share pledging, while another 22% restrict pledging to a degree.³ Notably, these restrictions appear less popular among companies with lower market capitalizations.

Even where prohibitions do not apply, getting a stock-based loan may be difficult. Banks often only accept public stock as collateral, which inhibits use of this strategy by private company executives. And, while some banks may lend against private company shares, loan approvals will be on a case-by-case basis. In addition, banks will likely only accept unrestricted shares, which means that much of the

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compensation an executive receives, such as restricted stock units (RSUs) or employee stock options, could not be used as collateral.

Equity Planning Considerations

Alongside these strategies, insiders may weigh other equity planning considerations to help them achieve diversification:

- *Increasing the amount withheld for taxes on vesting RSUs and on the exercise of non-qualified stock options.* For those insiders with less than \$1 million in compensation, companies may be able to withhold the maximum allowable level. In this way, the insider effectively sells more shares without appearing to have done so.
- *Creating a proactive equity plan.* This effort may include monitoring option expiry so as not to become “trapped” into an exercise-and-hold strategy in a closed sale window, selling net RSUs as they vest and coming up with a sale plan for long shares and options.

Executives at private companies may consider participating in tender offers in which private company employees receive the opportunity to sell shares at fixed prices. Executives should consider working with an equity planning specialist who can make tailored recommendations, before implementing these strategies.

Conclusion

Corporate executives and other insiders have multiple diversification strategies at their disposal, each of which comes with its own benefits and limitations. Tailoring an optimal strategy will depend on the client's specific circumstances, needs and preferences. Reach out to a Morgan Stanley Financial Advisor or your Financial Wellness or Stock Plan team to see how we can help to sort through the details.

End Notes

¹ [Final Rule: Insider Trading Arrangements and Related Disclosures](#).

² Avci, Sureyya Burcu; Schipani, Cindy A.; Seyhun, H. Nejat; and Verstein, Andrew. "[Insider Giving](#)." *Duke Law Journal*, 71:619 (2021). UCLA School of Law, Law-Econ Research Paper No. 21-02.

³ [Share Pledges Lose Popularity as Companies Clamp Down](#). May 10, 2022.

Disclosure Section

Risk Considerations

Direct indexing may only be appropriate for people who have a considerable amount to invest in a taxable account and want a level of customization they couldn't otherwise obtain through a portfolio of funds or individual securities. If you invest in a tax-deferred account, such as a 401(k) or IRA, the tax-harvesting benefits of direct indexing may provide no additional benefit to you. There is no guarantee that you will maximize value by tax-loss selling; holding onto slumping stock may have resulted in value greater than that obtained through tax-loss harvesting via direct indexing. In addition you will incur asset-based fees and expenses in a direct indexing account that may be higher than those for other investments, as well as transaction costs arising from customization and frequent rebalancing.

Alternative investments may be either traditional alternative investment vehicles, such as hedge funds, fund of hedge funds, private equity, private real estate and managed futures or, non-traditional products such as mutual funds and exchange-traded funds that also seek alternative-like exposure but have significant differences from traditional alternative investments. The risks of traditional alternative investments may include: can be highly illiquid, speculative and not appropriate for all investors, loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than open-end mutual funds, and risks associated with the operations, personnel and processes of the manager. Non-traditional alternative strategy products may employ various investment strategies and techniques for both hedging and more speculative purposes such as short-selling, leverage, derivatives and options, which can increase volatility and the risk of investment loss. These investments are subject to the risks normally associated with debt instruments and also carry substantial additional risks. Investors could lose all or a substantial amount of their investment. These investments typically have higher fees or expenses than traditional investments.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Companies paying **dividends** can reduce or cut payouts at any time.

An investment in an **exchange-traded fund** involves risks similar to those of investing in a broadly based portfolio of equity securities traded on an exchange in the relevant securities market, such as market fluctuations caused by such factors as economic and political developments, changes in interest rates and perceived trends in stock and bond prices. Investing in an international ETF also involves certain risks and considerations not typically associated with investing in an ETF that invests in the securities of U.S. issues, such as political, currency, economic and market risks. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics. ETFs investing in physical commodities and commodity or currency futures have special tax considerations. Physical commodities may be treated as collectibles subject to a maximum 28% long-term capital gains rates, while futures are marked-to-market and may be subject to a blended 60% long- and 40% short-term capital gains tax rate. Rolling futures positions may create taxable events. For specifics and a greater explanation of possible risks with ETFs, along with the ETF's investment objectives, charges and expenses, please consult a copy of the ETF's prospectus. Investing in sectors may be more volatile than diversifying across many industries. The investment return and principal value of ETF investments will fluctuate, so an investor's ETF shares (Creation Units), if or when sold, may be worth more or less than the original cost. ETFs are redeemable only in Creation Unit size through an Authorized Participant and are not individually redeemable from an ETF.

Please consider the investment objectives, risks, charges and expenses of the fund(s) carefully before investing. The prospectus contains this and other information about the fund(s). To obtain a prospectus, contact your financial advisor. Please read the prospectus carefully before investing.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

Individuals executing a **10b5-1 trading plan** should keep the following important considerations in mind:

1. 10b5-1 trading plans should be reviewed and approved by the legal and compliance department of the individual's company.
2. Most companies will permit 10b5-1 trading plans to be entered into only during open window periods.
3. Recent rule changes will require a mandatory cooling-off period between the execution of a 10b5-1 trading plan (or a modification) and the first sale pursuant to the plan (or the first sale following such modification).
4. 10b5-1 trading plans do not alter the nature of restricted and/or control stock or regulatory requirements that may otherwise be applicable (e.g., Section 16, Section 13).
5. 10b5-1 trading plans that are terminated early may weaken or cause the individual to lose the benefit of the affirmative defense.
6. 10b5-1 trading plans may require a cessation of trading activities at times when lockups may be required at the company (e.g., secondary offerings).
7. Recent rule changes will require companies to publicly disclose material terms of Section 16 director and officer 10b5-1 trading plans, and the early termination of such plans.

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