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Recommended Citation
Romano, Roberta and Bhagat, Sanjai, "Reforming Executive Compensation: Focusing and Committing to the Long-term" (2009). *Faculty Scholarship Series.* Paper 1921.
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Essay

Reforming Executive Compensation: Focusing and Committing to the Long-term

Sanjai Bhagat[†]
Roberta Romano[††]

This Essay offers an executive compensation reform proposal that is especially addressed to firms receiving government financial assistance and thought to pose a systemic risk, although we think that all firms should consider its adoption. Executive compensation reform should lead to policies that are simple, transparent, and focused on creating and sustaining long-term shareholder value. With these criteria in mind, we suggest that executive incentive compensation plans should consist only of restricted stock and restricted stock options, restricted in the sense that the shares cannot be sold or the option cannot be exercised for a period of at least two to four years after the executive's resignation or last day in office. We would permit a minor amount to be paid out to executives currently to address tax, liquidity, and premature turnover concerns that the proposal could induce. We believe that this approach will provide superior incentives for executives to manage corporations in investors' longer-term interest, and diminish their incentives to make public statements, manage earnings, or accept undue levels of risk, for the sake of short-term price appreciation. By reducing management's incentive to take on unwarranted risk, our proposal should therefore also decrease the threat that public resources will be wasted when a firm receives government assistance or is deemed by public officials as "too big to fail."

Introduction

Executive compensation is widely criticized for being excessive and for providing perverse incentives for reckless conduct. The issue has moved from the agenda of shareholder activists and media commentators to that of the

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† Professor of Finance, University of Colorado. For helpful suggestions on our proposal, we would like to thank Ian Ayres, Lucian Bebchuk, Ronald Gilson, Steven Kaplan, Edward Rock, Karin Thorburn, and participants at programs at the Northwestern, University of Pennsylvania, and Yale law schools.
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federal government, in the ongoing financial crisis that has led to large-scale government financial intervention in the private sector.

The financial-services industry rescue legislation, the Emergency Economic Stabilization Act of 2008 (EESA), for instance, had several provisions directed at limiting executive compensation in companies from which the Treasury Department was to acquire troubled assets.[1] As the rescue program transmuted into government purchase of equity interests in financial institutions instead of assets, rendering the EESA provisions apparently inapplicable, calls to restrict the compensation of executives of institutions receiving government funds increased steadily. The "rhetorical assault" by President Obama on Wall Street executives' bonuses as "shameful" echoed those sentiments.[2] In response to those concerns, Congress's stimulus package amended the EESA provisions to cap the salaries and bonuses of executives of firms receiving financial assistance under the Treasury Department's Troubled Assets Relief Program (TARP), among other restrictions.[3]

Further fueling the public onslaught against executive compensation, a provision in the stimulus package permitted the payment of $165 million in retention bonuses to American International Group (AIG) employees, despite the firm's massive bailout by the federal government. In response to the public outrage regarding the revelation of that action, the House passed punitive bonus tax legislation.[4]

Given the sour public mood in the midst of a financial crisis, additional attempts to restrict executive compensation can be expected, and they may extend beyond the financial sector that has been the recipient of government funds. For example, at the Senate confirmation hearing of Treasury Secretary Timothy Geithner, the committee chairman, Senator Carl Levin, asked the Secretary whether he would favor extending to all U.S. corporations and all employees the EESA provision that caps a corporation's income tax deduction for an executive's compensation of any form at $500,000 (compared to the current $1 million limit, which does not apply to incentive compensation).[5] Accordingly, we take this opportunity to suggest an approach to executive compensation that will better align incentives with investor interest.

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1 Pub. L. No. 110-343, § 111, 122 Stat. 3765 (2008).

2 Aaron Lucchetti & Matthew Karnitschnig, *On Street, New Reality on Pay Sets In*, WALL. ST. J., Jan. 31, 2009, at B1. Shortly thereafter, the Administration issued rules limiting the CEO's pay to $500,000 for financial institutions receiving government assistance. *See, e.g.*, Jonathan Weisman & Joann S. Lublin, *Obama Lays Out Limits on Executive Pay*, WALL ST. J., Feb. 5, 2009, at A1.

3 Incentive compensation and bonuses are prohibited unless paid in the form of restricted stock that does not vest until the TARP obligation period ends, and such compensation is limited to one-third of the total annual compensation the employee receives. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115 (2009).

4 H.R. 1586, 111th Cong. (2009) (imposing a 90% tax on bonuses paid to executives earning over $250,000, for companies accepting over $5 million in TARP funds).

5 *Executive Compensation: Geithner Gives Glimpse of Policy on Executive Compensation Under TARP*, 7 Corp. Accountability Rep. (BNA) 125 (Jan. 30, 2009).

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Rather than limit compensation to a dollar amount or prohibit bonus payments, compensation approaches that the academic literature indicates would be imprudent and counterproductive,[6] we recommend instead altering the *form* in which equity-based incentive compensation is provided to restricted stock, that is, equity interests that an executive could not sell until a specified number of years—we would suggest two to four—after he or she leaves a firm. We think that this form of compensation will provide managers of publicly-traded corporations with the proper incentives to operate the business in investors' and society's interest. We leave the decision to implement such a compensation policy in the hands of corporate directors and investors, along with the specific duration of the selling restriction, so that the particulars of employment could be tailored to specific firms' and individuals' needs.[7] We would, however, strongly urge the Treasury Department to require that such a compensation package be adopted by firms receiving government assistance. As we elaborate, our proposal is similar to, but somewhat more stringent than, an idea regarding limits on those firms' executive compensation that was initially floated by the Obama Administration, and that took what we consider to be a perverse form in the stimulus bill.[8]

I. Stock-Option Compensation Literature and Our Restricted-Stock Proposal

There is a well-developed and widely accepted economics literature on the fashioning of incentives to achieve consonance between managers' actions and shareholders' interest through the use of stock and stock-option compensation.[9] Until the spate of accounting scandals that began with Enron, compensation in the form of stock and stock options was often emphasized as a key to improved corporate performance, and such compensation has been the most substantial component of executive pay for well over a decade. Even Congress implicitly accepted the incentive function of executive compensation when in 1993 it eliminated the corporate income tax deduction for executive salaries in excess of $1 million, since the limitation was applicable only to non-incentive-based

6 *See infra* notes 22-24 and accompanying text. More recently, consistent with that literature, the Obama Administration has expressed concern that the compensation restrictions in the stimulus bill could be "counterproductive" and lead to a "brain drain" from U.S. institutions, suggesting that it would seek to rewrite the provisions. Sean Lengell, *Obama Seeking To Ease Limits on Executive Salaries*, WASH. TIMES, Feb. 16, 2009, at A09.

7 For a discussion of the need to tailor corporate governance mechanisms to individual firms' requirements, see Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1858-59, 1862-63 (2008).

8 *See infra* notes 21-26 and accompanying text. As noted earlier, the stimulus bill requires incentive compensation to take the form of restricted stock that cannot be sold until after TARP funds have been repaid, but also severely limits the amount that can be paid as incentive compensation.

9 *See, e.g.*, Bengt Holmstrom, *Managerial Incentive Problems—A Dynamic Perspective*, 66 REV. ECON. STUD. 169 (1999); Bengt Holmstrom, *Moral Hazard and Observability*, 10 BELL J. ECON. 4 (1979).

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compensation.[10] Moreover, an influential study by Michael Jensen and Kevin Murphy lent support to this view by documenting what the authors considered to be trivial responsiveness of executive compensation to stock performance: they calculated that CEO compensation changed by only $3.25 for a $1,000 change in stock value.[11] Jensen and Murphy viewed this disconnect to be a matter of considerable policy concern and advocated increasing equity incentive compensation.[12] Brian Hall and Josh Liebman documented a significant increase in incentive compensation since the publication of Jensen and Murphy.[13]

However, the tide of popular opinion turned against equity- and option-based compensation after the Enron and other corporate accounting scandals came to light, fueled by repeated assertions in the media from journalists, political officeholders, commentators, and public and union pension funds that executive compensation was unreasonably high. The heated rhetoric has only intensified with the political backlash to the financial panic and crisis, which began in 2007, and the government bailout of financial institutions commencing in 2008. This turn of events is not an altogether surprising development, as executive compensation has a long history of being targeted by populist attacks following market declines and scandals.[14] The accounting scandals revived executive compensation as an issue because some scandal-ridden firms' executives reported gains in the range of tens and hundreds of millions of dollars from exercising stock options before their firms imploded. Similarly, executives and employees of the financial institutions being aided by the government received billions of dollars in equity incentive compensation in the years running up to the current crisis, and some continued to receive large bonuses while their firms were suffering billions of dollars in losses.[15]

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10 I.R.C. § 162(m) (2006). The provision was enacted in 1993 as part of the Omnibus Budget Reconciliation Act, at a time of public criticism of executive compensation. *See, e.g.*, Nancy L. Rose & Catherine Wolfram, *Regulating Executive Pay: Using the Tax Code To Influence Chief Executive Officer Compensation*, 20 J. LABOR ECON. 138 (2002). Some commentators have attributed the Enron and related corporate scandals to that legislation. The contention is that, because managers could only receive substantial compensation in the form of stock and stock options, they had incentives to engage in accounting manipulation to maintain high stock prices. *E.g.*, Bruce Bartlett, *Not So Suite: Clinton Tax Law Is the Problem, Not Greedy Execs*, NAT'L REV. ONLINE, Sept. 25, 2002, http://www.nationalreview.com/nrof_bartlett/bartlett092502.asp.

11 Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990).

12 Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay But How*, 3 J. APPLIED CORP. FIN. 36 (1990).

13 Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?* 113 Q.J. ECON. 653 (1998).

14 *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 25-26 (rev. ed. 1995) (noting that compensation of bank executives was a critical focus of the Pecora hearings that provided the basis for federal securities regulation in the 1930s); Jensen & Murphy, *supra* note 11 (listing newspaper headlines attacking high executive compensation from the 1980s).

15 Lucchetti & Karnitschnig, *supra* note 2; Joe Nocera, *It's Not the Bonus Money, It's the Principle*, N.Y. TIMES, Jan. 31, 2009, at B1.

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Consistent with the academic literature, we think that incentive compensation in the form of stock and stock options is, in general, a highly effective mechanism for aligning manager and shareholder interests. However, in light of justifiable public concern over potentially perverse incentives from this form of compensation and instances of executive compensation amounts that would shock the conscience of any reasonable person, we suggest that instead of stock and stock options, incentive compensation plans should consist only of *restricted stock* and *restricted stock options*, restricted in the sense that the shares cannot be sold (or the option cannot be exercised) for a period of at least two to four years after the executive's resignation or last day in office. Why do we advocate a two- to four-year waiting period? We think two years should be the short end of the waiting period because managers' discretionary authority, under current accounting conventions in the United States, to manage earnings unravels within a one- to two-year period. On the other side, four years is a reasonable time for at least the intermediate-term results of the executives' decisions to come to realization.[16]

Executives who have a significant part of their incentive compensation in the form of such restricted stock and restricted options have diminished incentives to make public statements, manage earnings, or accept undue levels of risk, for the sake of short-term price appreciation. In this regard, the proposal will diminish the perverse incentives (to manipulate or emphasize short-term stock prices over long-term value), yet retain the benefits of equity-based incentive compensation plans. Managers with longer horizons will, we think, be less likely to engage in imprudent business or financial strategies or short term earnings manipulations when the ability to exit before problems come to light is greatly diminished.[17] Supporting our contention, Natasha Burns and Simi Kedia find, for example, that as a CEO's ownership of restricted stock increases, a company is less likely to be involved in financial misreporting.[18]

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16 Two recent papers present theoretical models of optimal manager incentive compensation. Both papers' models suggest that a significant component of incentive compensation should consist of stock and stock options with long vesting periods. Alex Edmans et al., Dynamic Incentive Accounts 3-4, 33 (Mar. 17, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1361797; Lin Peng & Ailsa Roell, Managerial Incentives and Stock Price Manipulation 20, 24-25 (Dec. 20, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1321903.

17 There is a well-established literature indicating that shareholders of acquirors lose wealth in acquisitions of public targets, particularly when financed by stock. Gregor Andrade, Mark Mitchell & Erik Stafford, *New Evidence and Perspectives on Mergers*, 15 J. ECON. PERSP. 103, 111 (2001). An ancillary benefit of our proposal is that senior managers and board members operating under a restricted-stock plan such as we have proposed should be less likely to engage in value-decreasing acquisitive transactions.

18 Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 79 J. FIN. ECON. 35, 63 (2006).

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II. Our Restricted Stock Proposal in Greater Detail

The idea of using restricted stock for executive incentive compensation is not original to us, but it is an approach that has been lost in the current populist agitation to reduce, rather than restructure, incentive compensation. For instance, many companies have restricted stock plans, the use of which began to increase after stock options were required to be expensed in firms' financial statements, thereby equalizing the accounting treatment of the two forms of compensation.[19] That change gave an edge to using restricted stock over options: with restricted stock, an employee still receives something of value if the stock price declines post-grant, compared to what would be a worthless under-water option.[20]

However, existing restricted stock plans differ from our proposal in an important respect: the vesting requirement is typically three years and the executive must still be employed at the end of the vesting period to receive the award. The stimulus bill, in line with a plan advanced by the Obama Administration, went beyond the existing plans and is closer to our proposal. It prohibited financial institutions receiving government TARP funds to pay executive incentive compensation in a form other than restricted stock that could not be sold until the government is repaid, while also capping the amount of such incentive pay at one-third of the executive's annual compensation.[21] But our proposal differs from Congress's mandate in three important—and we think critical—respects.

First, our proposal's term of the restricted stock is tied to the executives' term of employment (lasting two to four years after employment ends), and not the institution's indebtedness to TARP. We think this holding period better matches individual incentives with the taxpayers' and other equity holders' interests. Permitting the sale of the restricted shares upon repayment of TARP funds may encourage executives to repay the funds prematurely, at the expense of the financial institution's long-term value. Because TARP recipients, for the most part, are FDIC-insured institutions, that long-term value should be of concern to taxpayers, and not just the equity investors. Moreover, to the extent that exiting TARP quickly is in the equity's long-term interest, then our

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19 MARTIN E. PERSONICK, IRRC GOVERNANCE RESEARCH SERVICE 2005 BACKGROUND REPORT A: MANAGEMENT PROPOSALS ON EXECUTIVE COMPENSATION PLANS 8 (2005) (on file with author) (predicting trend to increased use of restricted stock and providing rationale); Martijn Cremers & Roberta Romano, *Institutional Investors and Proxy Voting: The Impact of the 2003 Mutual Fund Voting Disclosure Regulation* 16 (Yale Law & Econ. Research Paper No. 349, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=982493 (reporting significant increase in use of restricted stock before and after 2003 announcement that options would have to be expensed in 2005). All other things being equal, companies preferred compensation that was not expensed under accounting rules because that increased reported earnings.

20 PERSONICK, *supra* note 19, at 8.

21 American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115 (2009); *Executive Compensation*, *supra* note 5. The number of executives to whom the prohibition applies varies according to the amount of TARP assistance the financial institution has received.

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proposal will also achieve that objective, as the longer horizon in which the stock is held (post-repayment), aligns executives' incentives with that equity interest.

Successful executives—those who stay in office in firms which pay off TARP—will not have access to their incentive compensation as quickly as unsuccessful executives—those who are terminated before their firms pay off TARP—under our proposal compared to the stimulus bill's mandated plan. We do not see this as a problem. The unsuccessful executive terminated before the funds are repaid will still have to wait two to four years until the shares can be sold, and by then, the value of the company is not likely to still be affected by his decisions. (Of course, if by then the firm has repaid TARP, then the unsuccessful executive is in the same position under both our proposal and Congress's plan.)

Second, our proposal does not cap the amount of restricted stock that can be awarded the executives of TARP-recipients to a small fraction of total compensation, as did Congress. As noted earlier, incentive compensation is a more desirable form of executive pay than fixed compensation. Incentive compensation should therefore not be the smaller component. The problems thought to have been generated from equity incentive compensation in the past decade—earnings manipulation or the taking on of unwarranted risk—are a function of the *structure*, not the level, of the incentive payments.

Moreover, empirical research indicates that companies find a way to circumvent congressional limitations on compensation. The result is invariably higher and more opaque compensation, as adjustments are made to pre-regulation optimal compensation contracts; those adjustments can and have created perverse incentives for executives. For example, after Congress restricted the income tax deductibility of non-equity-incentive-based cash compensation to $1 million, firms altered the mix of compensation to reduce cash salaries and increase incentive compensation.[22] One cannot help but appreciate the irony that congressional action to reduce executive pay appears to have precipitated the mushrooming of equity incentive compensation, the bulk of which accounts for the very large amounts paid to executives that are the present object of attack, and that may have provided executives with increased incentives to engage in accounting improprieties (to maintain the value of their unrestricted stock options).[23]

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22 Tod Perry & Mark Zenner, Pay for Performance? Government Regulation and the Structure of Compensation Contracts 17 (2000) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=60956.

23 Burns & Kedia, *supra* note 18, at 63 (finding CEO compensation in stock options is significantly related to accounting restatements). *But see* Christopher S. Armstrong et al., *Chief Executive Officer Equity Incentives and Accounting Irregularities* 2-3, 11 (Rock Ctr. for Corporate Governance at Stanford Univ. Working Paper No. 4, 2008), *available at* http://ssrn.com/abstract=1132411 (using a different statistical technique, finding no relation between any form of CEO equity incentive compensation and accounting improprieties). However, to the best of our knowledge, no publicly held companies have an executive compensation plan exactly like the one we

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A similar reorientation of pay packages with perverse consequences occurred after the Sarbanes-Oxley Act of 2002 required clawbacks of incentive-based compensation when a firm's financials were restated: companies increased non-forfeitable, fixed-salary compensation and decreased incentive compensation, thereby providing insurance to managers for increased risk.[24] As critics of executive compensation, including President Obama, object to large pay packages that are independent of performance, firms' adaptation to the clawback provisions had precisely the opposite effect of what they would wish to see of a pay package. Our proposal, which does not place artificial and counterproductive limits on the amount of incentive compensation, as does the stimulus bill, will avoid such perversely counterbalancing behavior by firms.[25]

Third, our proposal applies to all executives and not, as does the stimulus bill, only to the "most highly compensated" employee(s). We believe the broader coverage is necessary because decisions of individuals such as proprietary traders, who may well not be among a financial institution's highest compensated individuals, can adversely affect, indeed implode, a firm. Attention must thereby be directed at ensuring that their incentives are aligned with a firm's long-term performance, and not a transaction's short-term impact.

We would, accordingly, encourage the Administration, when adopting guidelines to implement the stimulus legislation, to consider requiring TARP recipients to implement restricted stock plans whose duration will last a specified period—such as our suggested two to four years—beyond an employee's departure even if it occurs after the government is repaid. If that

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are recommending here, and so the studies' findings cannot truly inform us of what would be the effect of executive compensation policies that allow only restricted stock and restricted stock options as incentive compensation. Some financial firms do not permit executives to sell stock (or a substantial amount of their accrued incentive stock compensation) prior to their retirement or certain departures, similar to our proposal. In particular, it has been noted to us that AIG, until Hank Greenberg retired as CEO in 2005, had a long-term deferred equity compensation plan that did not pay out the shares to executives until retirement under an arrangement with Starr International Company (Greenberg's company that owned approximately twelve percent of AIG). *See* American International Group, Inc. Proxy Statement 7-10 (Apr. 5, 2004), *available at* http://www.sec.gov/Archives/edgar/data/5272/000095011704001279/a37136.htm. That was not the exclusive form of incentive compensation as AIG also had stock-option grant programs with more conventional vesting terms. *Id.* at 11. But if, as Greenberg states, AIG did not write credit-default swaps in huge volumes until after he retired and the incentive compensation post-retirement vesting period changed, that is consistent with our contention that our proposal will more properly align executive incentives with shareholders' interest than existing shorter-horizon plans. Bei Hu, *AIG Shouldn't Have Paid Unit Bonuses, Greenberg Says*, BLOOMBERG, Mar. 26, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aM1tb.djytxs&refer=home.

24 Daniel A. Cohen et al., The Sarbanes-Oxley Act of 2002: Implications for Compensation Structure and Managerial Risk-Taking (Nov. 9, 2007) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027448. While it is unlikely that pay levels in the financial services sector will be as high in the future as they were in the past, Cohen and others' research suggests that it is highly probable that the industry compensation structure will change to include higher base pay to offset reduced bonuses in response to the publicly-expressed outrage at bonus payments by the President and others.

25 We also take account of the need to make adjustments to pay in order to compensate for the restricted form of incentive pay of our proposal, *see infra* text accompanying notes 28 & 30.

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would seem to be overstepping by the government—since we advocate the voluntary adoption of such plans by non-governmentally-assisted firms—we would suggest, as a minimum, that the government mandate that the shares continue to be restricted two to four years *after* TARP is repaid, to obtain the more desirable incentive effects generated by such an horizon.

We do not think that it would be overreaching to continue to impose our proposal on firms after they have repaid TARP funds to the extent that those firms are still obtaining other forms of government financial assistance (through access to the Federal Reserve Bank's discount window or participation in guaranteed short-term debt or deposit insurance programs). Indeed, we believe that the use of restricted stock plans as the sole form of incentive compensation should be mandated for managers of financial institutions whose liabilities are guaranteed by the government through the federal deposit insurance program, and not simply those receiving EESA funds, to align managerial incentives against excessive risk-taking and thereby protect the fisc.[26]

A further benefit of our proposal is its natural "clawback" feature that renders unnecessary intricate mechanisms requiring executives to pay back bonuses received on income from transactions whose value proved illusory. Because executives are compensated in equity that is not received until years after it is earned—two to four years after they leave the firm—they cannot capture short-lived income from transactions whose value is not long-lasting: the "compensation" will be dissipated as the value of the firm's shares decline. This automatic "clawback" is simpler to administer than the clawbacks mandated in legislation such as the stimulus bill and the Sarbanes-Oxley Act, which require specific triggers, such as an accounting restatement, and can be subject to litigation to resolve a host of thorny issues, such as whether an item in a financial statement was material or whether scienter is required for forfeiture of the incentive compensation.[27]

We note three important caveats to the proposal. First, if executives are required to hold restricted shares and options, then they would most likely be under-diversified. This would lower the risk-adjusted expected return for the executive. One way of bringing the executive's risk-adjusted expected return back up to the former level (that before the executive was required to hold the shares and options) would be to increase the expected return by granting additional (restricted) shares and options to the executive. To ensure that the incentive effects of restricted stock and options are not undone by self-help

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26 Value-based deferred-credit-type incentive plans, similar to restricted stock plans, could be designed for executives of non-stock (mutual) institutions. Small institutions, for which the systemic risk to the FDIC fund is trivial, could be exempt from the restricted stock requirement in exchange for paying a higher fee to the insurance fund to account for the higher risk of loss from having less desirable incentive pay structures.

27 American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115 (2009); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 15 U.S.C. § 7243 (2006).

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efforts at diversification, executives participating in these compensation plans should be prohibited from engaging in derivative transactions, such as equity swaps, or borrowing arrangements, that enable them to hedge their interest in the restricted shares.

In addition, to ensure that under-diversification does not result in managers taking a suboptimally low level of risk, compared to the risk preferences of shareholders (behavior that may be of particular concern as an aging executive nears retirement and may wish to protect the value of accrued shares), the incentive plan can be fine-tuned to provide a higher proportion in restricted options than shares to increase the incentive to take risk.[28] Of course there is a tradeoff with respect to using restricted options rather than stock in an effort to reduce managerial risk aversion: from the perspective of protecting the fisc, when the assistance takes the form of deposit insurance rather than government equity ownership, a more risk-averse executive may be precisely what is desired.

Second, if executives are required to hold the restricted shares and options past retirement, it would raise concerns regarding a lack of liquidity.[29] To offset the loss of liquidity, we propose first that there be a higher limit on cash compensation for tax deductibility purposes, up to, say, $2 million for executives who receive equity compensation in the form of restricted stock,[30] compared to the existing $500,000 limit for executives of financial institutions receiving TARP funds and $1 million limit for all others. In addition, we propose that 85% to 90%, and not all, of the incentive compensation received

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28 Holmstrom, *supra* note 9.

29 The executive would also be exposed to the impact of decisions made by his successor. This will have the beneficial effect of focusing the executive more attentively on succession planning. It could also increase the executive's incentive to sell the company at a low price in order to cash out upon retirement. But the strategy of accepting a low price would be constrained by the need for shareholder approval (whether by tendering their shares or voting for the merger or asset sale) and by the probability that a low price would attract a competing bidder. To the extent that these constraints are not perfect, this is a tradeoff in which, in our judgment, the cost of our proposal (a potential increase in sales at "too low" a price) is outweighed by the benefit (a reduction in mismatched incentives to engage in "too risky" transactions whose short term profit may result in imploding the firm in the long term). The concern that restricted stock will encourage low-priced sales only involves cash offers, which are less likely to produce low valuations compared to stock offers, given the higher premiums paid in cash transactions. *See, e.g.*, Andrade et al., *supra* note 17, at 111 (abnormal stock returns for large cash acquisitions 50% higher than those for stock deals). If the consideration for the sale is stock or securities, then the post-retirement two- to four-year holding period for the executive's restricted stock would attach to those instruments.

30 I.R.C. § 162(m) (2006). We would therefore undo the decrease in the deduction contained in the EESA, and counsel against the suggestion for expanding the reduction in deductibility to all firms. *See supra* note 5. David Walker suggests that firms might respond to this piece of our proposal by increasing fixed cash compensation and reducing the amount of incentive compensation, attenuating the link between pay and performance. David I. Walker, *The Challenge of Improving the Long-term Focus of Executive Pay* 25 (Boston Univ. School of Law Working Paper No. 09-222009), *available at* http://ssrn.scom/abstract=1396663. We think that permitting earlier access to a modest percentage of annual restricted stock compensation should mitigate such a possible outcome. But even if it were insufficient to avert such a reaction, in our judgment the cost would be more than offset by the undesirable perverse incentives—encouraging misstatements, earnings manipulation, and excessively high risk strategies—of existing compensation plans.

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in a given year be in the form of restricted stock or options whose receipt is postponed until two to four years beyond the term of employment. Thus, the executive would be able to access a small proportion (the remaining 10% to 15% in a given year) in the shorter time frame prevalent in existing restricted stock plans or in the year of receipt.

Whether our proposal adequately addresses well-founded concerns regarding liquidity can be better appreciated when framed by real-world comparisons. Our proposal requires executives to not sell their shares or exercise their options for a period of at least two to four years after their last day in office. The median tenure of CEOs in larger U.S. corporations is about five years.[31] Hence, on average, a CEO can expect to wait about seven to nine years before being allowed to sell shares or exercise options.[32] We would also note a parallelism between our proposal and compensation in the non-public corporation setting, which buttresses the feasibility of our proposal: it is quite common for those firms' top executives to wait for seven to ten years before receiving a substantial portion of their compensation for work done earlier. For instance, the general partners of private equity partnerships typically receive their compensation in two parts. The first part is a management fee which is about two percent annually of the committed capital they are managing. The second part of the compensation is carried interest, which is a fraction (usually, 20%) of the lifetime profits generated by the private equity partnership. Most of these profits are realized towards the end of the life of such partnerships, usually seven to ten years.[33] The widespread use of such a deferred compensation structure in a real world setting where principal-agent problems are thought to be well-managed, suggests that our proposal not only is viable but also could improve substantially corporate managers' incentives, despite well-known differences between the private equity and public company operating environments.

Third, to the extent an executive incurs tax liability from receiving restricted shares and options that is greater than the amount permitted to be received in the current year, then that individual should be allowed to sell enough additional shares (and/or exercise enough options) to pay those additional taxes.

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31 Sanjai Bhagat, Brian J. Bolton & Ajay Subramanian, *Manager Characteristics and Capital Structure: Theory and Evidence*, tbl. 5 (Univ. of Colo. Working Paper 40, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1360244.

32 Of course, many CEOs are employed at lower executive levels before reaching the top, and therefore the time frame in which they would not have access to their accrued incentive compensation would be longer. This is an ancillary reason for our advocacy of release of 10-15% of the incentive compensation of a given year from the long-term restriction.

33 ANDREW METRICK, VENTURE CAPITAL AND THE FINANCE OF INNOVATION (2007); Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Agreements*, (Univ. of Tex. Law & Econ. Research Paper No. 29, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=555626.

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In addition to the above caveats, there are two important questions about the efficacy of our proposal that need to be addressed. First, should not managers be rewarded on the basis of relative performance, that is, performance relative to an industry or targeted market benchmark? The suggestion has obvious merit in that controlling for industry or market performance would provide an arguably better measure of the manager's contribution to share price performance.[34] However, as noted at the outset, we think it is critical for executive compensation reform to lead to policies that are simple and transparent. Relative performance measures are at odds with this aim, given the ambiguities and correlative ability to game the selection of the appropriate industry or market benchmark.[35] Additionally, with relative

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34 Some have criticized the stimulus bill's mandate of restricted stock for covering executives who are lower level managers with limited responsibilities, on the ground that it is preferable to tie those individuals' pay to the unit rather than the company as a whole. Lucian Bebchuk, *Congress Gets Punitive on Executive Pay*, WALL ST. J., Feb. 17, 2009, at A15. That may be true but misses the mark as it moves incentive compensation away from benchmarks that are simple, transparent, and not easily manipulable. The market currency of stock prices is a far better benchmark for performance than the accounting-based measures used to assess units' performance, which are themselves manipulable. Moreover, one could address the criticism by combining a unit performance benchmark with the restricted-stock approach, by allocating restricted shares to lower-level managers in proportion to their unit's accounting performance compared to the rest of the company.

35 A recent executive compensation proposal by Lucian Bebchuk and Holger Spamann suffers from similar difficulties. They advocate that bank executives' pay should consist of a package of securities, replicating proportionally in value, the bank's capital structure. Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay* (Harvard John M. Olin Ctr. for Law, Econ., & Business Discussion Paper No. 641, 2009), *available at* http://ssrn.com/abstract=1410072. It is not simple to implement their proposal, and because it is not likely to resolve the problem to which it is directed, reducing bank executives' incentives to take risk, we think the tradeoff in added complexity should be considered carefully.

In particular, Bebchuk and Spamann's proposal would require determining the market values of illiquid securities, as is the preferred stock the government owns, which in the first version of the proposal is the only security that would be added to equity in the compensation package mix of securities. *Id.* at 36. Valuing untraded securities is not only difficult, but is correlatively also easily gamed. The proposal would be even more complex to administer in the iterations they suggest that include adjusting market valued-compensation packages by subtracting government payments to depositors, and other government support payments, or with ever-increasing intricacy, subtracting expected future increases in government payments. *Id.* at 37. Moreover, in the case of Citigroup, the government has become an equity holder with the conversion of its preferred stock, a position that complicates the proposal's assumed level of risk that is in the taxpayers' interest. In addition, large banks are subsidiaries of bank holding companies, which have additional operating subsidiaries not federally insured, and it would be quite difficult to determine which entity's capital structure should be replicated or how they should be combined to set optimal risk-taking incentives.

Finally, although in theory by giving an executive a mix of all of a bank's securities the individual might not take on inappropriate risk, in practice we think it would be otherwise. Even if the value of the manager's equity position is quite low compared to the senior securities in the pay package, the manager would still have an incentive to take on risky projects, given the option value of the position each year, compared to our restricted stock proposal, because with restricted stock the option value cannot be realized until years after the manager is no longer with the firm. Indeed, as we discussed earlier, restricted stock is more likely to decrease than increase managers' risk-taking, because it increases the underdiversification of their portfolio, in addition to having a long-term holding period. *See supra* pp. 367-8. Bebchuk and Spamann would appear to recognize this problem with their proposal, as they proceed to adopt a piece of our proposal when they suggest that the payoff from their compensation package of adjusted-market-valued securities could be delayed until a year after the executive departs. Bebchuk & Spamann, *supra*, at 37.

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performance measures it is possible for managers to receive significant compensation even when their shareholders incur significant losses; this result would again undermine the credibility of manager compensation in the eyes of the investing and general public. Our proposal does not present such a perceptual problem.

Second, would our proposal lead to early management departures, as executives seek to convert (after the two to four year waiting period) illiquid shares and options into more liquid assets as soon as possible? We tend to think this scenario is overblown, but perhaps that would be so. Permitting a fraction (10% to 15% as we have proposed) of each year's incentive compensation to vest and be sold should mitigate this concern, particularly for lower-level managers, whose bonuses may not be as large as, and whose employment horizons under normal circumstances would be longer than, those of the CEO. Further, informing our skepticism regarding this objection is our expectation that managers who develop a reputation for early departures from firm to firm are likely to negatively impact their future career opportunities.[36] Finally, concern for managers' need for liquidity and consequent early departures needs a bit of perspective. Our proposal allows deductible cash compensation up to $2 million for executives receiving incentive pay in the form of restricted stock. The adjusted gross income (AGI) of the top 0.5% in 2004 had a threshold of $0.48 million, and the AGI of the top 0.1% in 2004 had a threshold of $1.4 million.[37]

III. Conclusion

The financial institutions' rescue legislation, stimulus bill, and recently introduced bills' punitive taxes on executive compensation may quench the public's anger over perceived excesses in executive compensation, but they are not an adequate solution to the problem of compensation providing poor incentives. Our proposal would have incentive compensation take the form of only restricted stock and restricted stock options (restricted in the sense that the securities may not be sold or exercised until two to four years after the executive has left the firm), with a modest amount accessible by the executive to address tax, liquidity and premature turnover concerns. While our proposal is hortatory for public companies, we would mandate it for financial firms receiving TARP funds or other government financial assistance, such as participation in debt guarantee or deposit insurance programs. Our proposal protects the fisc while providing superior incentives for executives to manage

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36 There is evidence of reputational effects in the market for managers: managers of public firms that file for bankruptcy, for example, do not appear to get a second chance at managing a public company. Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241 (1989).

37 Steven Kaplan & Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* (CRSP Working Paper No. 615, 2007), *available at* http://ssrn.com/abstract=931280.

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corporations in investors' longer-term interest and avoiding the perverse incentives of both an artificial cap on incentive compensation and of unrestricted stock and option compensation plans.

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