

Reforming Executive Compensation: Focusing and Committing to the Long-term¹

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This essay offers a proposal to reform executive compensation 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, it 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 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

¹ We would like to thank for helpful suggestions on our proposal, Ian Ayres, Lucian Bebchuk, Ronald Gilson, Steven Kaplan, Karin Thorburn, and participants at programs at the Northwestern, University of Pennsylvania and Yale law schools.

compensation in companies from which the Treasury Department was to acquire troubled assets.² As the rescue program transmuted into government purchase of equity interests in financial institutions instead of assets, rendering the EESA provisions apparently inapplicable, calls, steadily increased to restrict the compensation of executives of institutions receiving government funds, The “rhetorical assault” by President Obama on Wall Street executives’ bonuses as “shameful” echoed those sentiments.³ In response to those concerns, Congress’ 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.⁴

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

2 Pub. L. No. 110-343 (2008). The compensation provisions are in section 111 of the Act.

3 Aaron Lucchetti & Matthew Karnitschnig, *On Street, New Reality on Pay Sets In*, WALL ST. J., Jan. 31-Feb.1, 2009, at B1. Shortly thereafter, the administration issued rules limiting the CEO’s pay to \$500,000 for financial institutions receiving government assistance. E.g., Jonathan Weisman & Joann S. Lublin, *Obama Lays Out Limits on Executive Pay*, WALL ST.J., Feb. 5, 2009, at A1.

4 America Recovery and Reinvestment Act of 2009 (“stimulus bill”), Pub. L. No. 111-5, § 7001 (2009). 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 1/3 of the total annual compensation the employee receives. The stimulus bill retained the restrictions in legislation prohibiting incentive pay that had been introduced in the House but not those in the Senate, which would have capped compensation at \$400,000, the salary of the President of the United States.

government. In response to the public outrage regarding the revelation of that action, the House passed punitive bonus tax legislation.⁵

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, that does not apply to incentive compensation).⁶ Accordingly, we take this opportunity to suggest an approach to executive compensation that will better align incentives with investor interest.

Rather than limit compensation to a dollar amount or prohibit bonus payments, compensation approaches that the academic literature indicates would be imprudent and counterproductive,⁷ 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

⁵ H.R. 1586 (imposing 90 percent tax on bonuses paid to executives earning over \$250,000, of companies accepting over \$5 million in TARP funds), passed March 19, 2009, *see* <http://thomas.loc.gov/cgi-bin/query/C?c111:./temp/~c111Izx2jQ>

⁶ *Executive Compensation: Geithner Gives Glimpse of Policy on Executive Compensation under TARP*, 7 Corp. Accountability Rep. (BNA) 125 (Jan. 30, 2009).

⁷ *See* text and accompanying notes 22-24, *infra*. 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,

firm. We think that 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.⁸ 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.⁹

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

There is a well-developed and widely-accepted economics literature on the fashioning of incentives to achieve consonance between manager's actions and shareholders' interest through the use of stock and stock option compensation.¹⁰ Until the spate of accounting scandals that

suggesting that it would seek to rewrite the provisions. Sean Lengell, *Obama seeking to ease limits on executive salaries*, WASHINGTON TIMES, Feb.16, 2009, at A01.

⁸ For a discussion of the need to tailor corporate governance mechanisms to individual firms' requirements see Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1858-59, 1862-63 (2008).

⁹ See text and accompanying notes 21-26, *infra*. As earlier noted, 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.

¹⁰ See, e.g., Bengt Holmstrom, *Moral Hazard and Observability*, 10 BELL J. ECON. 4 (1979) (hereinafter Holmstrom, *Moral Hazard*); Bengt Holmstrom, *Managerial Incentive Problems - A*

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 compensation.¹¹ 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.¹² Jensen and Murphy viewed this disconnect to be a matter of considerable policy concern and advocated increasing

Dynamic Perspective, in *ESSAYS IN ECONOMICS AND MANAGEMENT IN HONOR OF LARS WAHLBECK* 209 (1982).

11 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.* S138 (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, available at http://www.nationalreview.com/nrof_bartlett/bartlett092502.asp.

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

equity incentive compensation.¹³ Brian Hall and Josh Liebman documented a significant increase in incentive compensation since the publication of Jensen and Murphy.¹⁴

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.¹⁵ 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

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

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

15 See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 25-26 (rev. ed. 1995) (example of how a critical focus of the Pecora hearings that provided the basis for federal securities regulation in the 1930s was the compensation of bank executives); Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, Working Paper 43 (June 4, 1989) (listing newspaper headlines attacking high executive compensation from the 1980s), available at <http://www-rcf.usc.edu/~kjmurphy/jmjpe.pdf>.

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.¹⁶

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 executive's decisions to come to realization.¹⁷

¹⁶ Lucchetti & Karnitschnig, *supra* note 3; Joe Nocera, *It's Not the Bonus Money, It's the Principle*, N.Y. TIMES, Jan. 31, 2009, at B1.

¹⁷ 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. Lin Peng & Ailsa Roell, *Managerial Incentives and Stock Price Manipulation* 20, 24-25 (unpublished manuscript 2008), available at <http://ssrn.com/abstract=1321903>. Alex Edmans, Xavier Gabaix, Tomasz Sadzik & Yuliy Sannikov, *Dynamic Incentive Accounts* 3-4, 33 (unpublished manuscript 2009), available at <http://ssrn.com/abstract=1361797>.

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. 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

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

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

¹⁹ MARTIN E. PERSONICK, IRRRC GOVERNANCE RESEARCH SERVICE 2005 BACKGROUND REPORT A: MANAGEMENT PROPOSALS ON EXECUTIVE COMPENSATION PLANS 8 (Apr. 2005) (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*

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 1/3 of the executive's annual compensation.²¹ But our proposal differs from Congress' 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

Voting Disclosure Regulation 16 (unpublished manuscript 2008), 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 199, at 8.

²¹ Stimulus bill, *supra* note 4; *Executive Compensation*, *supra* note 6. The number of executives to whom the prohibition applies varies according to the amount of TARP assistance the financial institution has received.

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 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' 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. It 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

²² Tod Perry & Mark Zenner, *Pay for Performance? Government Regulation and the Structure of Compensation Contracts* 17 (unpublished manuscript 2000), 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 (unpublished manuscript 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1132411 (using a different statistical technique, finds 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 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 option 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 12 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-

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 and

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 Press (Mar. 26, 2009), available at <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* (unpublished manuscript 2007), 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 et al.'s 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* text at notes 28 & 30 *infra*.

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 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 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

²⁶ Value-based deferred credit-type incentive plans, similar to restricted stock, plans, could be designed for executives of nonstock (mutual) institutions. Small institutions, for which the systemic risk to the FDIC fund is trivial, could be exempt from the restricted stock requirement,

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 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 efforts at diversification, executives participating in these compensation plans should be prohibited from engaging in derivative transactions, such

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 Section 7001 of the stimulus bill, *supra* note 4, to be codified at 12 U.S.C. §5221; section 304 of the Sarbanes-Oxley Act, Pub. L. No. 107-204, codified at 15 U.S.C. § 7243.

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, compared to the existing \$500,000 limit for executives of financial institutions receiving TARP funds and \$1 million limit for all others, for executives who receive equity compensation in the form of restricted stock.³⁰ In addition, we propose that 85 to 90 percent, and

²⁸ Holmstrom, Moral Hazard, *supra* note 10.

²⁹ The executive would also be exposed to the impact of decisions made by the new executive. This will have the beneficial effect of focusing the executive more attentively on succession planning.

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 6.

not all, of the incentive compensation received 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 10-15 percent 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, twenty percent) of the lifetime profits generated by the private equity partnership. Most

31 Sanjai Bhagat, Brian J. Bolton & Ajay Subramanian., *Manager Characteristics and Capital Structure: Theory and Evidence*, Univ. of Colo. Working Paper 40 (2009) (table 5), 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 or advocacy of release of 10-15

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.

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

percent 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.

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

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. Additionally, with relative performance measures it is possible for managers to receive significant compensation even when their shareholders incur significant losses; this 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 (10-15 percent 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, and whose employment horizons under normal circumstances would be longer, than that 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.³⁵ 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. The adjusted

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 There is evidence of reputational effects in the market for managers: managers of public firms that file for bankruptcy 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

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.³⁶

III. Conclusion

The financial institutions' rescue legislation, stimulus bill, and recently introduced bills' limits and 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 option* (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). 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 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.

(1989).

³⁶ Steven Kaplan & Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?* (unpublished manuscript 2007), available at <http://ssrn.com/abstract=931280>.