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THE CHALLENGE OF IMPROVING THE LONG-TERM FOCUS OF EXECUTIVE PAY

DAVID I. WALKER*

Abstract: A consensus is developing that executive compensation in the United States is inadequately linked to long-term company performance, resulting in reckless, short-term decision making. Congress, the Obama administration, and academic commentators have recently embraced dramatic restrictions on the form and holding period of senior executive pay, at least for some companies. A common view is that although regulation of the amount of executive pay would do more harm than good, regulation of form and term is desirable. This Article questions that view. It highlights the challenges of fruitfully regulating the form and term of pay arising from the complexity and diversity of executive pay arrangements, uncertainty as to the underlying reasons and hence appropriate remedies for short-termism, and the conflict between deterring reckless short-term behavior and encouraging sufficient risk-taking to maximize share value over the long term. It analyzes and critiques existing regulatory proposals, and, although not endorsing a regulatory solution, offers two ideas that policy makers should consider if faced with crafting a regulatory response to short-termism: first, focusing regulation solely on the term of pay, leaving form to company discretion, and second, adopting a comprehensive disclosure-based response.

INTRODUCTION

Executive compensation in the United States is under intense scrutiny by legislators, regulators, and investor advocates. Excessive or poorly structured compensation arrangements have been blamed for the U.S. financial crisis of 2008, as well as the malfeasance in recent years at Enron, WorldCom, and other major American corporations.¹ A

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¹ See, e.g., Judith F. Samuelson & Lynn A. Stout, Op-Ed., *Are Executives Paid Too Much?*, WALL ST. J., Feb. 26, 2009, at A13 (attributing the financial crisis to short-term thinking, driven in part by compensation plan design).

key complaint is that executive compensation is insufficiently focused on the long term, leading to reckless, short-term decision making by executives, and, at the extreme, financial bubbles that inevitably burst with negative consequences extending far beyond the employees and shareholders of the companies directly involved.²

After years of much rhetoric but little action, it appears that the federal government may be poised to take meaningful steps to increase executive compensation regulation. Moreover, combating short-termism appears to be high on the agenda. The federal bailout legislation passed in early 2009 specifies that incentive compensation granted to senior executives must be in the form of restricted stock that may not vest until the government loans are repaid,³ and influential members of Congress advocate broader application of rules tying executive pay to long-term performance.⁴ Academic commentators seem to agree. Even some commentators who do not favor capping the amount of executive compensation favor restrictions on the form and term of executive pay.⁵ For example, Professors Sanjai Bhagat and Roberta Romano have recently recommended that 85–90% of executive incentive pay take the form of restricted stock or restricted stock options that cannot be sold or exercised during employment or for two to four years following termination.⁶ To be sure, Bhagat and Romano only propose mandating such a rule for firms receiving bailout funds; otherwise, they would leave the decision to individual boards of directors.⁷ On the other hand, Judge Richard Posner has recently advocated that firms be required to deliver a minimum percentage of chief executive officer (“CEO”) pay in the form of restricted stock that could not be sold for some specified number of years.⁸

² See *id.*

³ See American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 516–18.

⁴ See, e.g., Susanne Craig, *Cuomo, Frank Seek to Link Executive Pay, Performance*, WALL ST. J., Mar. 13, 2009, at C1 (relating comments of U.S. House of Representatives Financial Services Committee Chairman Barney Frank).

⁵ See Sanjai Bhagat & Roberta Romano, Essay, *Reforming Executive Compensation: Focusing and Committing to the Long-term*, 26 YALE J. ON REG. 359, 361 (2009); Richard A. Posner, Essay, *Are American CEOs Overpaid, and, If So, What If Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1045–46 (2009).

⁶ See Bhagat & Romano, *supra* note 5, at 363, 368–69.

⁷ See *id.* at 361. Bhagat and Romano do, however, suggest extending a mandatory regime to all FDIC-insured institutions. See *id.* at 367; see also Samuelson & Stout, *supra* note 1 (advocating that executives be required to hold “a significant portion of their equity for a period beyond their tenure,” but not suggesting that such a rule be mandated).

⁸ See Posner, *supra* note 5, at 1045–46.

Of course, company directors can be encouraged to link executive pay more closely to long-term performance, but given the current push for more coercive measures, this Article considers the possible role of federal regulation in deterring reckless behavior, earnings manipulation, and other pathologies associated with short-termism. It is not concerned specifically with compensation at bailed-out firms, or even at financial firms generally, but with broadly applicable executive pay regulation that could or should follow from the current crisis.⁹

Part I of this Article examines the complex question of why and to what extent short-termism exists.¹⁰ It discusses possible explanations including market myopia, managerial myopia, and the effects of externalities and past regulatory efforts.

Part II details five generic challenges to any regulatory intervention aimed at combating short-termism.¹¹ It argues that attempting to regulate the form and term of executive compensation is as challenging as attempting to regulate the amount. Any regulatory response would have to consider the uncertainty as to the underlying reasons (and hence appropriate remedies) for short-termism, and the potential conflict between deterring reckless short-term behavior and encouraging sufficient risk taking to maximize share value over the long term.¹² Such a response would also have to account for the substantial complexity and diversity of current executive pay arrangements as well as the possibility of circumvention and other unintended consequences.¹³ As an example of the conflict between deterring recklessness while encouraging sufficient risk taking, consider a rule that would force executives to hold a creditor risk in their companies until retirement. Such a rule might be an excellent way of deterring earnings manipulation and bet-the-company risks but might cause executives to act too conservatively, undermining long-term value maximization.

Part III then examines five existing programs and proposals for combating short-termism, revealing several serious concerns that sug-

⁹ As Professor Jeffrey Gordon argues: “Compensation design in financial firms can have systemic effects” that call for a distinct and specific regulatory approach. See Jeffrey N. Gordon, Essay, “Say on Pay”: *Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 363–66 (2009) (proposing compensation structures that force employees of financial firms to internalize the risks they create).

¹⁰ See *infra* notes 19–44 and accompanying text.

¹¹ See *infra* notes 45–94 and accompanying text.

¹² See *infra* notes 48–61 and accompanying text.

¹³ See *infra* notes 62–94 and accompanying text.

gest that these approaches may not be suitable as models for executive pay regulation generally.¹⁴ For example:

- Approaches that would restrict incentive pay to one or two equity-based instruments would eliminate valuable diversity in executive pay arrangements, barring not only short-term incentives, but also non-equity arrangements that tie executive wealth to firm performance over the long term.
- Approaches that would require executives to hold equity until retirement would impose significant burdens on executives in terms of reduced liquidity and under-diversification. These burdens would increase the wedge between the cost of equity incentives to shareholders and their value to executives.
- In order to avoid circumvention, approaches that would restrict the term of incentive pay must be tightly circumscribed, e.g., by capping the amount of non-incentive pay or specifying a percentage of pay that must be in the form of long-term incentives. As a result, existing proposals either impose inefficient one-size-fits-all solutions on diverse firms, industries, and executives or are easily circumvented.¹⁵

Finally, Part IV of this Article considers how federal regulation directed at short-termism might be shaped to increase the chances that the benefits would outweigh the harms.¹⁶ After all, some additional regulation may be inevitable, and relatively less coercive regulation might even be desirable. Part IV, therefore, offers two ideas for combating short-termism. First, it argues that policy makers should consider focusing regulation solely on the term of pay while leaving the choice of instrument to individual companies in order to preserve as much efficient diversity in pay arrangements as possible.¹⁷ Term-only regulation is not unambiguously preferable to existing proposals because of the risk that it would result in excessive conservatism, but it would get at the root of the current short-termism concern and is an option that should be on the table if regulation is to be pursued. Second, depending on the ultimate source of the short-termism phenomenon, disclosure-based regulation focused on the average holding period of executive pay could help mitigate the worst examples of short-termism while

¹⁴ See *infra* notes 95–160 and accompanying text.

¹⁵ See *infra* notes 95–160 and accompanying text.

¹⁶ See *infra* notes 161–175 and accompanying text.

¹⁷ See *infra* notes 164–169 and accompanying text.

avoiding many of the costs and unintended consequences of compulsory regulation.¹⁸

The bottom line is that regulating the term of executive pay is no less challenging than regulating the amount and may not be worth undertaking. Legislators, regulators, and other observers may be frustrated by this situation, but it is important that they recognize the potential pitfalls.

I. WHAT IS SHORT-TERMISM, AND WHY DOES IT EXIST?

Perhaps the leading corporate governance concern of legislators and commentators at present is the reckless pursuit of short-term profits by corporate executives who will have cashed out before the long-term repercussions are felt. The pathology sometimes appears in the form of earnings manipulation, which often involves sacrificing long-term share value to boost near-term earnings.¹⁹ Enron Corp., where earnings manipulation was practiced as an art and eventually evolved into fraud leading to bankruptcy, is the poster child for this branch of short-termism.²⁰ Short-termism, however, often takes the form of completely legal, but excessively risky behavior, such as banks adopting lax lending standards or financial firms taking on too much exposure to derivatives. Aspen Institute Business and Society Program founder Judith Samuelson and Professor Lynn Stout have argued that the “overarching cause” of the 2008 financial crisis was “business leaders taking on excessive risk in the quest to increase next quarter’s profits.”²¹ To be clear, the concern is not just that executives fail to establish sufficient risk controls, but that executives affirmatively seek out high risk, high short-term return strategies.²²

¹⁸ See *infra* notes 170–175 and accompanying text.

¹⁹ See, e.g., John R. Graham et al., *Value Destruction and Financial Reporting Decisions*, FIN. ANALYSTS J., Nov.–Dec. 2006, at 27, 31 (reporting results of a survey of over 400 chief financial officers indicating that over half of respondents were willing to sacrifice shareholder value in order to achieve earnings targets).

²⁰ See Paul M. Healy & Krishna G. Palepu, *The Fall of Enron*, 17 J. ECON. PERSP. 3, 9–11 (2003) (describing Enron’s abusive use of mark-to-market accounting and special purpose entities to manipulate earnings).

²¹ See Samuelson & Stout, *supra* note 1.

²² Although earnings manipulation and reckless risk taking may be viewed as two manifestations of a common phenomenon, their remedies may be quite different. For example, clawback provisions in executive compensation agreements that allow firms to recoup bonuses paid based on inaccurate financial results that are later restated may be an effective means of combating earnings manipulation but would not mitigate excessive risk taking. See, e.g., 12 U.S.C.A. § 5221(b)(3)(B) (West 2001, Supp. 2009 & Supp. I 2009) (requiring TARP participants to have provisions in place for the recovery “of any bonus, retention

Why does short-termism allegedly run rampant in corporate board rooms? Most commentators point to short-term accounting-based bonuses that incent managers to maximize current-year profits at the expense of long-term share value²³ and short-vesting stock options that cause managers to prefer strategies that increase stock price volatility, even if those strategies do not maximize expected returns. But compensation arrangements can only be a proximate cause; they cannot be an ultimate cause of short-termism. Why are compensation arrangements too short-term focused? As we will see in this Part, that is a very complex question, and its elusiveness is one reason that combating short-termism is so difficult.²⁴

A. Market Myopia

One possible explanation for short-term focused compensation arrangements is that these arrangements reflect myopic investor preferences.²⁵ Shareholders, in other words, do not want managers to focus on the long term any more than they already do. Indeed, Samuelson and Stout argue that “institutional and individual investors alike [have become] preoccupied with quarterly earnings forecasts and short-term share price changes.”²⁶

However, in order for the stock market as a whole to exhibit myopia—that is, to account for myopia existing in an environment populated with sophisticated arbitrageurs—one must posit a market imperfection, such as information asymmetry, which leads to systematic discounting of long-term opportunities.²⁷ Although it is certainly plausible that investors would have relatively greater difficulty evaluating managerial claims regarding the costs and benefits of long-term pro-

award, or incentive compensation paid to [specified executives and employees] based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate”).

²³ See Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, in CORPORATE RESTRUCTURING AND EXECUTIVE COMPENSATION 3, 10–11 (Joel M. Stern et al. eds., 1989).

²⁴ See *infra* notes 25–44 and accompanying text.

²⁵ On market and managerial myopia, see Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655 (1989) [hereinafter Stein, *Efficient Capital Markets*]; Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61 (1988) [hereinafter Stein, *Takeover Threats*]; Brian Cadman & Jayanthi Sunder, *The Role of Investor Horizon on Compensation Horizon* (Sept. 1, 2009) (unpublished manuscript, available at <http://ssrn.com/abstract=956601>).

²⁶ Samuelson & Stout, *supra* note 1.

²⁷ See Stein, *Takeover Threats*, *supra* note 25, at 62–63.

jects,²⁸ empirical evidence concerning the existence of market myopia is mixed.²⁹ Of course, if the market is myopic, one would expect executive compensation arrangements to reflect this myopia and to focus excessively on current earnings generation.

B. *Managerial Myopia*

Even if markets are not inherently myopic, managers might be. First, managers might believe that the market is myopic and shape their own behavior accordingly.³⁰ Second, consistent with a model developed by Professor Jeremy Stein, managers might rationally behave myopically as a result of a sort of prisoner's dilemma, in which they are trapped in myopic behavior even if they know that the market would be efficient in equilibrium.³¹ Third, in some cases, managers might have a shorter investment horizon than shareholders because they expect to retire or leave the company in the near term and hence are not motivated to pursue long-term goals.³²

In these situations, managerial and investor preferences are not aligned, and one must invoke agency costs to explain why managers would be allowed to act on their myopic preferences. Suppose the market is not inherently myopic, but managers are. In order to overcome managerial myopia, managerial wealth should be tied to firm performance over the longer term, which, in the view of finance theorists, helps explain vesting requirements on stock and options, and long-term in-

²⁸ See Samuelson & Stout, *supra* note 1 (“It is extremely difficult for an outside investor to gauge whether a company is making sound, long-term investments by training employees, improving customer service, or developing promising new products.”).

²⁹ The empirical evidence on both market and managerial myopia is inconclusive. It has been suggested that the growth of private equity buyouts, which free firms to focus on long-term gains, is some evidence of market myopia. See Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1086 (2007). Others point to positive stock market reaction to long-term investment as evidence against market myopia. See Jensen, *supra* note 23, at 10–12. Professor Jeremy Stein notes, however, that such behavior is consistent with managerial myopia since shareholders will highly value new investment approved by managers who are generally reluctant to invest. See Stein, *Takeover Threats*, *supra* note 25, at 77.

³⁰ See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 865 (1992) (arguing that corporate managers may think institutional investors are myopic leading “managers to behave myopically, in the misguided belief that doing so will placate institutional hunger for a quick buck”).

³¹ See Stein, *Efficient Capital Markets*, *supra* note 25, at 656–61 (positing model in which current earnings signal future earnings, firms inflate current earnings to signal future prospects, investors discount current earnings accordingly, but no firm can credibly defect).

³² See Black, *supra* note 30, at 865.

centive plans with multi-year horizons.³³ But managers resist having too much of their wealth tied to long-term performance because of the negative effects on the diversification of their portfolios and liquidity. The optimal pay arrangement would balance the shareholders' desire for long-term incentives against managerial risk aversion and liquidity concerns. As a result, even the optimal pay arrangement would be more short-term focused than shareholders would prefer.³⁴

In addition, managers have every incentive to reduce their risk exposure, below the level ostensibly agreed to, by negotiating hard on seemingly insignificant details of their compensation, such as vesting schedules *ex ante*, and through hedging, backdating option grants, and similar schemes *ex post*.³⁵ If one is a fervent believer that corporate boards of directors faithfully and capably represent shareholder interests and that executive pay arrangements reflect optimal contracting, there would be less of a reason to worry about inadequate term from the shareholders' perspective. If, however, one believes that managers exert significant control over their own pay packages, one would expect pay arrangements to be appreciably short-term focused.³⁶

³³ See Cadman & Sunder, *supra* note 25, at 6–7 (citing sources).

³⁴ Cf. Keith J. Crocker & Joel Slemrod, *The Economics of Earnings Manipulation and Managerial Compensation*, 38 RAND J. ECON. 698, 701, 707 (2007) (demonstrating that in a hidden action model, in which managers take actions to increase profits that are never observed by shareholders, the optimal managerial compensation contract would permit some earnings manipulation).

³⁵ At the extreme, hedging transactions can completely eliminate firm-specific risk. See David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 455 (2000). As a result of backdating, executives effectively replaced risky at-the-money options, issued with an exercise price equal to the fair market value of the stock on the grant date, with less risky in-the-money options that had an exercise price lower than the market value on the grant date. See David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 570–76 (2007).

³⁶ See Lucian Ayre Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 774–79 (2002) (proposing a managerial power theory of the executive pay setting process). Under a managerial power view of the executive compensation-setting process, pay is capped in part by investor outrage, and managers therefore seek out low-salience means of boosting their pay. See *id.* at 786–91. One way to subtly increase the value of a pay package is to decrease its risk, and shortening the term of equity and non-equity incentives is one way to decrease risk. See *id.* at 828 (discussing broad manager freedom to exercise options well before expiration as an inconspicuous way to increase value).

C. Externalities

Next, even if the capital markets accurately and efficiently gauge short- and long-term opportunities and risks, pay arrangements might be too short-term focused from a social perspective. Not all of the costs that result from myopic firm behavior are borne by parties to the contracts, at least not in the cases in which short-termism has been taken to an extreme. At Enron, at WorldCom, and certainly at the banks at the center of the subprime mortgage-sparked financial crisis, a significant portion of the cost has been borne by employees who own few shares, by suppliers, by the communities at large, and in some cases by taxpayers. If the shareholders and the managers retain between them a larger fraction of the gains from short-term, risky behavior when such behavior pays off than they do of the costs when things go wrong, one would expect firms to take on more risk and for pay packages to be more short-term focused than would be optimal for society as a whole.³⁷

D. Regulatory Push

Finally, past regulation of executive pay may have encouraged short-termism by promoting compensation in the form of stock options. First, although by the early 1990s accountants were generally of the view that the cost of stock options should be recognized as an expense for financial accounting purposes, the Financial Accounting Standards Board failed to mandate option expensing until 2004.³⁸ Prior to this, options were uniquely free goods from an accounting perspective, whereas the compensation alternatives—restricted stock, accounting-based incentives, and, of course, salary—all resulted in an expense under generally accepted accounting principles (“GAAP”).³⁹

³⁷ This, of course, is the standard problem associated with negative externalities. See generally R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960) (discussing efficient ways to distribute risk of harm between businesses and society).

³⁸ See FIN. ACCT. STD. BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123: SHARE-BASED PAYMENT, at iii–iv, 1 (revised 2004) [hereinafter SFAS 123R] (requiring “fair value” accounting for all equity compensation including options); FIN. ACCT. STD. BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123: ACCOUNTING FOR STOCK-BASED COMPENSATION 17–18 (1995) (requiring firms to present pro forma income statements including option expense, but not mandating fair value accounting for options).

³⁹ See David I. Walker, *Financial Accounting and Corporate Behavior*, 64 WASH. & LEE L. REV. 927, 953–57 (2007) (discussing the accounting treatment of options and implications). See generally William W. Bratton, *Private Standards, Public Governance: A New Look at the Financial Accounting Standards Board*, 48 B.C. L. REV. 5 (2007).

Second, in promulgating Internal Revenue Code (“IRC”) § 162(m) in 1993, Congress encouraged firms to redirect executive salaries into options.⁴⁰ Section 162(m) limits tax deductions for certain senior executive compensation to \$1 million per year but provides an exception for performance-based pay, and the regulations made it easy to qualify conventional stock options as fully deductible executive compensation.⁴¹ Both of these decisions made stock options particularly attractive as a compensation device and may have contributed to over-use.⁴²

The accounting treatment of options has now been rationalized, and aggregate use of options by U.S. companies is much reduced versus the late 1990s and early 2000s.⁴³ That change may have already reduced short-termism pressure to some extent, but many companies continue to rely heavily on stock option compensation for their most senior executives.⁴⁴

II. FIVE GENERIC CHALLENGES TO A REGULATORY RESPONSE TO SHORT-TERMISM

This Part explores five generic challenges to regulatory intervention aimed at combating short-termism that might be underappreciated by regulators or commentators.⁴⁵ Part III will then consider several specific approaches to regulating the link between executive pay and long-term firm performance based on the 2009 economic stimulus legislation and suggestions of commentators.⁴⁶ It will be shown that each has serious shortcomings as a model for general coercive regulation.⁴⁷

⁴⁰ See I.R.C. § 162(m) (West 2002 & Supp. 2009).

⁴¹ See *id.* § 162(m)(1), (4)(C); Treas. Reg. § 1.162-27(e)(2)(vi)(A) (as amended in 1996) (deeming conventional non-discounted options and stock appreciation rights (“SARs”) to qualify as performance-based pay if certain minimal procedural requirements are satisfied).

⁴² See Walker, *supra* note 39, at 953–57 (discussing anecdotal and empirical evidence that the anomalous accounting treatment of options was a primary factor in their growing use in the 1990s).

⁴³ See David I. Walker, *Evolutionary Executive Equity Compensation and the Limits of Optimal Contracting* 18 (Boston Univ. Sch. of Law, Law & Economics Research Paper Series, Paper No. 09-34, 2009), available at <http://ssrn.com/abstract=1443170> (documenting that stock option compensation, including SARs, constituted over 60% of the aggregate ex ante compensation of S&P 500 senior executives in 2000, and showing that by 2007 the fraction had declined to 25%).

⁴⁴ See *id.* at 27–28 (documenting that 17% of S&P 500 senior executives received options as their only equity incentives in 2007).

⁴⁵ See *infra* notes 48–94 and accompanying text.

⁴⁶ See *infra* notes 95–160 and accompanying text.

⁴⁷ See *infra* notes 95–160 and accompanying text.

A. *Uncertain Source and Extent Equals Uncertain Remedy*

As discussed above, there are several factors that may have contributed to short-term behavior.⁴⁸ Moreover, although theory suggests that short-termism could be systemic, there is much uncertainty regarding the pervasiveness and significance of the problem. Discussion of short-termism tends to focus on the failings of specific firms such as Enron, WorldCom, and AIG, but thousands of public companies in the United States exhibit no signs of pathological short-term behavior. Furthermore, the author is aware of no empirical evidence establishing that executive pay term is inadequately focused on long-term performance from either a shareholder or a societal perspective, systemically.⁴⁹

This uncertainty increases the difficulty of shaping a regulatory remedy. For example, if short-termism is primarily the result of market myopia or externalities, a coercive response might be indicated. Presumably, company directors would need to be prodded to take steps contrary to the priorities of their executives and their shareholders. If, however, managerial agency problems and compensation opacity are the key contributors, improved disclosure could be a reasonable first step towards combating short-termism.⁵⁰ Similarly, if short-termism is

⁴⁸ See *supra* notes 25–44 and accompanying text.

⁴⁹ There is, however, empirical evidence linking earnings management with strong equity incentives. See, e.g., Pengjie Gao & Ronald E. Shrieves, *Earnings Management and Executive Compensation: A Case of Overdose of Option and Underdose of Salary?* 26 (July 29, 2002) (unpublished manuscript, available at <http://ssrn.com/abstract=302843>) (finding a positive relationship between earnings management intensity and option and bonus amounts and incentive intensity of current year stock option awards); Bin Ke, *Do Equity-Based Incentives Induce CEOs to Manage Earnings to Report Strings of Consecutive Earnings Increases?* 2–3 (July 31, 2005) (unpublished manuscript, available at <http://ssrn.com/abstract=446540>) (finding that firms whose CEOs have high equity-based incentives are more likely to manage earnings). On the other hand, evidence of a link between executive compensation design and accounting fraud is mixed. See Crocker & Slemrod, *supra* note 34, at 699–700 (reviewing the literature).

To the author's knowledge, no one has studied the relationship between equity or incentive compensation vesting periods and governance, although that relationship would seem to be central to this issue. Perhaps variation in vesting periods is inadequate to produce statistically significant results, but although modest, there is some variation in equity compensation vesting periods from firm to firm. See FREDERICK W. COOK & CO., *THE 2008 TOP 250: LONG-TERM INCENTIVE GRANT PRACTICES FOR EXECUTIVES* 17 (2008), http://www.fwcook.com/alert_letters/2008_Top_250.pdf. Options vest in three years at roughly half of large U.S. companies, in four years at about 30% of firms, and in five years at about 15% of companies. *Id.*

⁵⁰ U.S. public companies routinely claim that their executive compensation programs are designed to ensure a focus on long-term shareholder value. See, e.g., Eli Lilly & Co., Proxy Statement (Form DEF 14A), at 23 (Mar. 10, 2008) (stating that “compensation should foster a long-term focus”). Indeed, proxy materials often specifically assert an emphasis on long-term incentives over short-term incentives. See, e.g., Johnson & Johnson, Proxy Statement

systemic, this suggests more coercive regulation is necessary; if, however, it is limited to a subset of firms, less coercive regulation may be in order.

The federal government has never attempted strongly coercive regulation of executive pay. Previous regulation generally has taken the form of tax incentives and disclosure requirements.⁵¹ As will be discussed, strongly coercive regulation carries significant risks and costs, which may be difficult to justify without more certainty regarding the source and extent of the problem.⁵²

B. *Mitigating Short-Termism and Avoiding Excessive Managerial Conservatism May Be in Tension*

Interestingly, although corporate finance researchers have long been concerned with executive appetites for risk, their focus has generally been on the problem of excessive *conservatism* on the part of risk-averse executives.⁵³ Because executives' human capital and often a disproportionate amount of their financial capital is tied up in their firms, executives are inherently more risk averse than diversified shareholders.⁵⁴ As a result, executives would tend to be more conservative than shareholders would prefer them to be in selecting projects, making acquisition decisions, etc., and fail to maximize the long-term value of the enterprise.⁵⁵ Of course, this conservatism problem is much more subtle than the recklessness problem that is the center of attention today. Nothing blows up if executives are too conservative.

Paying executives with restricted stock, which increases exposure to employer share price, tends to increase risk aversion and conservatism.⁵⁶ On the other hand, the lack of personal downside risk and the tremendous upside potential provided by stock options can increase

(Form DEF 14A), at 27, 46 (Mar. 12, 2008) (claiming that its targeted CEO "pay mix" consists of 70% long-term incentives, but excluding from the calculation about \$3 million of perks and other benefits received by the CEO during the fiscal year). As will be shown, however, given the complexity and diversity of modern executive compensation programs, claims such as these are difficult to assess objectively utilizing existing proxy disclosures. See *infra* notes 62–76 and accompanying text.

⁵¹ See *infra* notes 80–94 and accompanying text.

⁵² See *infra* notes 105–160 and accompanying text.

⁵³ See, e.g., John E. Core et al., *Executive Equity Compensation and Incentives: A Survey*, FRBNY ECON. POL'Y REV., Apr. 2003, at 27, 33 (summarizing research).

⁵⁴ See, e.g., *id.*; Richard A. DeFusco et al., *The Effect of Executive Stock Option Plans on Stockholders and Bondholders*, 45 J. FIN. 617, 618 (1990).

⁵⁵ See Core et al., *supra* note 53, at 33; DeFusco et al., *supra* note 54, at 618.

⁵⁶ See Core et al., *supra* note 53, at 33.

executive appetites for taking on risk at the firm level.⁵⁷ This is the traditional corporate finance explanation for the inclusion of options in executive compensation packages.⁵⁸

The tension between mitigating recklessness and avoiding excessive conservatism is obvious. Although options can induce executives to take share value-enhancing risks, they can lead to excessive risk taking and earnings manipulation in imperfect capital markets that fail to completely and instantly incorporate these activities into share prices.⁵⁹ Forcing executives to hold restricted stock until retirement would mitigate earnings manipulation and bet-the-company risk taking, but, as noted, stockholdings actually increase executive risk aversion and conservatism.⁶⁰ Avoiding recklessness and excessive conservatism requires a very fine balancing act that would seem to be quite difficult to achieve with one-size-fits-all regulation.⁶¹

C. *Existing Executive Compensation Arrangements Are Complex and Diverse*

Executive pay arrangements are more complex and diverse than is generally recognized. Some of the complexity and diversity may be unnecessary, but there is evidence that the diversity increases the efficiency of executive pay arrangements. As this section explains, that di-

⁵⁷ See *id.* (noting that it is optimal to add options to a manager's compensation package when the manager's project selection choices affect firm risk). Options do not necessarily cause managers to seek risk, however. See Jennifer N. Carpenter, *Does Option Compensation Increase Managerial Risk Appetite?*, 55 J. FIN. 2311, 2311 (2000). Options have an incentive effect, as described in the text, but they can also produce a risk aversion effect. See *id.* at 2311–12. An option that is far in the money, for example, resembles restricted stock and may discourage risk taking. Moreover, whether the incentive effect or risk aversion effect dominates depends on the risk aversion "profile" of the manager. See *id.* at 2311–13; Core et al., *supra* note 53, at 33; Thomas Hemmer et al., *Introducing Convexity into Optimal Compensation Contracts*, 28 J. ACCT. & ECON. 307, 308–10 (2000).

⁵⁸ See, e.g., Hemmer et al., *supra* note 57, at 308 ("It is often claimed that the advantage of stock options is that they mitigate excessive risk avoiding behavior on the part of managers.").

⁵⁹ Cf. Crocker & Slemrod, *supra* note 34, at 700, 707 (showing that when managers can conceal actions and information from shareholders, a compensation contract based on reported earnings cannot provide managers with the incentive both to maximize profits and report them honestly).

⁶⁰ See *supra* notes 53–58 and accompanying text.

⁶¹ Although the conservatism problem is not inherently a long-term or short-term phenomenon, there are long-term and short-term aspects. Excessively risk-averse executives tend to prefer shorter-term, more incremental projects, such as cost cutting, which are relatively safe, to longer-term research and development intensive projects, which are relatively risky. Thus, conservatism could be viewed as a second and conflicting "short-termism" problem. In order to avoid confusion, however, this Article refers to the latter problem as conservatism and reserves the short-termism label for recklessness.

versity makes one-size-fits-all approaches to combating short-termism problematic.

It is quite common today for a senior executive of a Standard & Poor's ("S&P") 500 company to receive base salary; one or more annual bonus opportunities; various equity-based and cash-based long-term incentive pay grants, such as restricted stock, stock options, performance shares, stock appreciation rights ("SARs"), and long-term incentive plan ("LTIP") units;⁶² as well as supplemental retirement contributions, and various other perks and benefits. As a result of this complexity, the discussion and analysis section of proxy statements detailing this compensation now routinely runs twenty to thirty pages.⁶³

Not only are executive pay practices complex; they are also increasingly diverse among firms. Comparing the pay of executives at different firms had become so difficult that in 2006 the Securities and Exchange Commission ("SEC") began requiring companies to disclose a bottom line total compensation figure for each senior executive whose pay is detailed in the firm's proxy statement.⁶⁴

Executive incentive pay arrangements, in particular, have become much more varied over the last decade. Ten years ago, conventional stock options dominated the landscape at U.S. public companies,⁶⁵ but

⁶² For more detail on these instruments and their use by the largest U.S. public companies, see FREDERICK W. COOK & Co., *supra* note 49, at 4–13. Restricted stock is stock that is granted to an employee provisionally. The stock is forfeited if it fails to vest because employment is terminated before the vesting date, or, in some cases, because performance requirements for vesting are not satisfied. *See id.* at 5. Stock options provide the right but no obligation to purchase company shares at a predetermined exercise price between a vesting date and an expiration date. *Id.* Performance shares are similar economically to restricted stock, but employees receive performance shares after vesting conditions are met, rather than before. *See id.* at 5–6. SARs are contractual rights that are economically equivalent to options. *See id.* at 9. LTIPs are typically accounting-based incentive plans with payoffs determined by firm performance over a several year period. *See id.* at 5–13, 18–19.

⁶³ *See, e.g.*, Eli Lilly & Co., Proxy Statement (Form DEF 14A), at 23–43 (Mar. 10, 2008) (twenty-one pages); Johnson & Johnson, Proxy Statement (Form DEF 14A), at 21–52 (Mar. 12, 2008) (thirty-two pages).

⁶⁴ *See* Executive Compensation and Related Person Disclosure, Securities Act Release No. 33-8732A, Exchange Act Release No. 34-54302A, Investment Company Act Release No. 27444A, 71 Fed. Reg. 53,158, 53,170 (Sept. 8, 2006) (modifying the summary compensation table to require disclosure of "total" compensation figures); *see also* Executive Compensation and Related Party Disclosure, Securities Act Release No. 33-8655, Exchange Act Release No. 34-53185; Investment Company Act Release No. 27218, 71 Fed. Reg. 6542, 6548 (Feb. 8, 2006) (proposing modifications and discussing motivation).

⁶⁵ At the peak of the dot-com boom in 2000, stock options accounted for over 60% of the total compensation of senior S&P 500 executives as measured on an ex ante basis. *See* ExecuComp Data (on file with author). The author's calculation is based on data compiled from S&P's ExecuComp database, available by subscription at <http://mi.compustat.com/>. *See generally* Walker, *supra* note 43 (describing the data collection methodology).

their prevalence was in part the result of favorable accounting treatment that was eliminated in 2004.⁶⁶ Today the regulatory playing field for stock, options, and non-equity incentives is much more level,⁶⁷ and the use of these instruments is more balanced and diverse. In 2007, for example, stock options and SARs accounted for only about 33% of the total long-term incentive compensation of the senior executives of S&P 500 companies.⁶⁸ Restricted stock and performance units accounted for about 44%, and non-equity, accounting-based plans accounted for the remaining 23%.⁶⁹ These figures exclude annual incentives, which are also generally based on accounting performance.⁷⁰ They also gloss over significant variations within the categories. Conventional time-vested restricted stock and stock options probably accounted for only about 50% of total long-term incentive compensation for senior S&P 500 executives for 2007.⁷¹

The current diversity in compensation instruments may be greater than is optimal from a shareholder or social perspective,⁷² but empirical evidence suggests that diversity increases the efficiency of compensation. For example, there is evidence that the mix of stock and options granted to executives varies predictably with firm characteristics such as size and growth opportunities.⁷³

⁶⁶ See SFAS 123R, *supra* note 38.

⁶⁷ See David I. Walker & Victor Fleischer, *Book/Tax Conformity and Equity Compensation*, 62 TAX L. REV. 399, 402–08 (2009) (discussing the tax, accounting, and disclosure treatment of various equity compensation instruments).

⁶⁸ ExecuComp Data, *supra* note 65.

⁶⁹ *Id.*

⁷⁰ Annual incentives accounted for about 6% of total 2007 compensation for senior S&P 500 executives. *Id.*

⁷¹ Author's estimate based on ExecuComp data and a sample of hand-collected proxy statements allowing for subdivision of options into conventional options and SARs, and stock into conventional restricted stock, performance-vested restricted stock, and performance shares. See *id.*

⁷² The question of why these arrangements have become so complex and diverse is interesting, although largely beyond the scope of this Article. The optimistic story would be that diversity in company and executive circumstances has led to the diversity in optimal pay arrangements. The author has presented a more pessimistic view elsewhere, namely that the complexity and diversity serve to obfuscate pay and reduce investor backlash. David I. Walker, *The Manager's Share*, 47 WM. & MARY L. REV. 587, 632–40 (2005); accord Bebchuk et al., *supra* note 36, at 786–91 (proposing a managerial power theory of the executive pay setting process in which obfuscation reduces investor outrage that restrains pay). Although the pessimistic view suggests that shareholders might benefit from simplified executive pay packages, it does not imply that the menu of compensation choices should be limited legislatively.

⁷³ See John Core & Wayne Guay, *The Use of Equity Grants to Manage Optimal Equity Incentive Levels*, 28 J. ACCT. & ECON. 151 (1999); Wayne R. Guay, *The Sensitivity of CEO Wealth to Equity Risk: An Analysis of the Magnitude and Determinants*, 53 J. FIN. ECON. 43 (1999). Of

Regulatory approaches that would restrict the form of compensation in a quest to combat short-termism threaten to reduce this diversity and potentially the efficiency of pay arrangements.⁷⁴ The idea of restricting incentive pay to a particular instrument or instruments is even more problematic when combined with the idea of requiring executives to hold the instrument for an extended period. We have little experience with very long-term executive incentive pay arrangements and really no idea which instruments would best link pay and performance over longer periods. Less than 5% of firms utilize stock or options that vest more than five years in the future,⁷⁵ and, interestingly, although a few firms utilize incentives that remain in place until retirement, some of those plans are based on accounting results rather than stock prices.⁷⁶

D. *Short-Termism Is a Function of More Than Annual Compensation*

Annual executive pay packages seem to be a natural starting point for attempting to combat short-termism, and many proposals adopt this perspective, but the executive incentive picture is much more complex than annual pay arrangements alone would suggest. First, the incentives associated with an executive's most recent pay package make up only a small part of the executive's total compensation-related incentives.⁷⁷ In order to properly analyze (or influence) executive incentives, one must look at the "stock" of incentives accumulated over time in the form of shares, unexercised options, and other long-term arrange-

course, we cannot know the incremental value of the diversity in executive compensation composition. The value could be relatively small, but the economic stakes are large.

⁷⁴ Professor Jeffrey Gordon argues that shareholder "say on pay" mandates could result in much less diversity in executive pay arrangements as a result of the likely role played by proxy advisory firms and the incentives at those firms. *See* Gordon, *supra* note 9, at 350–53. He raises similar concerns regarding the potential loss of efficiency from more one-size-fits-all pay arrangements. *See id.* at 329–35, 361–63. In Gordon's view, efficient executive pay arrangements should be expected to be diverse because executive pay serves several different functions, the importance of which vary from firm to firm and from time to time for particular firms. *See id.*

⁷⁵ *See* FREDERICK W. COOK & Co., *supra* note 49, at 17 (reporting that stock options vest beyond five years at only 2% of surveyed firms and that restricted stock grants vest beyond five years at only 4% of firms).

⁷⁶ *See, e.g.*, Johnson & Johnson, Proxy Statement (Form DEF 14A), at 29–30 (Mar. 12, 2008) (describing "Certificate of Extra Compensation Plan" under which executives receive units that are valued based on the company's net asset value and earnings power per share and which are payable on retirement).

⁷⁷ *See* FREDERICK W. COOK & Co., *supra* note 49, at 4–13.

ments, not just the annual “flow” of incentives.⁷⁸ Second, the economic incentives of founders and some other executives may be dominated by equity holdings that were not accumulated through compensation at all. Third, compensation is not the sole source of incentives. For example, the prospect of advancement or the threat of dismissal creates incentives that are related to compensation but vary considerably depending on an executive’s age and career arc.⁷⁹

All of these incentives, and others, would affect the propensity of managers to engage in short-term, reckless behavior. It is obviously very difficult for firms to manage these complex webs of incentives and even more difficult for a regulator to do so. Regulation focused solely on current year compensation is even less likely to hit the mark.

E. Previous Attempts to Regulate Executive Pay Have Resulted in Circumvention and Unintended Consequences

Previous attempts to regulate executive pay at the federal level have consisted largely of tax incentives and SEC-mandated pay disclosure.⁸⁰ These initiatives have achieved mixed success at best, and often have resulted in circumvention or unintended consequences. These experiences provide lessons for those wishing to regulate the form or term of executive pay.

1. Tax Incentives

In the last twenty-five years, Congress has twice turned to the tax code in an attempt to influence executive pay practices. We have already encountered IRC § 162(m), which was enacted in 1993 and limits a corporation’s tax deduction for non-performance-based pay granted to certain senior executives to \$1 million per year.⁸¹ There is some uncertainty as to the goals Congress had in mind in enacting this provi-

⁷⁸ See Core et al., *supra* note 53, at 30–31 (arguing that it is more appropriate to look at the stock than the annual flow in evaluating the level of incentives).

⁷⁹ See, e.g., Atreya Chakraborty et al., *Termination Risk and Managerial Risk Taking*, 13 J. CORP. FIN. 170, 171 (2007) (arguing that managerial investment decisions “depend not only on how a manager’s compensation changes with firm risk but also on how his/her job is affected if the project fails”); Greg Hallman et al., *Carrots and Sticks: Incentive Compensation and the Likelihood of Termination 1* (Oct. 13, 2008) (unpublished manuscript, available at <http://ssrn.com/abstract=1122548>) (arguing that termination provides a powerful incentive for executives apart from their compensation and may partially offset the need to provide incentives through other channels).

⁸⁰ See *infra* notes 81–87 and accompanying text.

⁸¹ I.R.C. § 162(m) (West 2002 & Supp. 2009); see *supra* notes 40–42 and accompanying text.

sion, but if it was meant to slow the increase in total executive pay, it was almost certainly unsuccessful.⁸² If the provision was meant only to redirect pay from straight salary to more performance-sensitive channels, it was successful, but may have inadvertently sparked the executive stock option boom of the 1990s.⁸³

There is both good news and bad news here for proponents of regulation improving the link between executive pay and long-term performance. On the positive side, the § 162(m) experience suggests that it may be easier to influence the design of compensation than the amount. On the negative side, the experience highlights how difficult it is to balance executive incentives. Section 162(m) may have been too successful in increasing the performance sensitivity of executive pay.

No more effective, apparently, was Congress's 1984 attempt to rein in excessive "golden parachute" executive severance packages by restricting corporate tax deductions for parachute payments and imposing excise taxes on recipients of excess payments.⁸⁴ Although the rule initially led to some firms capping parachute payments at the maximum amount deductible, over time companies began to exceed the cap, forfeit the deduction on the excess, and "gross up" executives with an additional payment to compensate them for the excise tax, effectively shifting the entire cost of non-compliance to the shareholders.⁸⁵

⁸² See Robert F. Göx, Tax Incentives for Inefficient Executive Pay and Reward for Luck 2 (Mar. 12, 2008) (unpublished manuscript, available at <http://ssrn.com/abstract=823884>) (reporting that the "average total pay of S&P 500 CEOs rose from \$2.6 million in 1993 to \$14 million in 2000" and remained at \$9.4 million in 2002 even after the burst of the dot-com stock market bubble); see also Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 917–20 (2007) (describing empirical evidence indicating that § 162(m) was associated with an increase in executive pay).

⁸³ See Brian J. Hall & Jeffrey B. Liebman, *The Taxation of Executive Compensation*, in 14 TAX POLICY AND THE ECONOMY 1, 36 (James M. Poterba ed., 2000) (finding that post-1993 salary reductions were more than offset by additional stock option grants); see also Polsky, *supra* note 82, at 906 & n.125 (documenting the widespread belief among informed observers that § 162(m) contributed to the options explosion, but also noting the lack of clear cut empirical evidence).

⁸⁴ See I.R.C. §§ 280G, 4999 (denying deduction and imposing excise tax on severance payments in excess of an executive's average compensation over the previous five years).

⁸⁵ See Bruce A. Wolk, *The Golden Parachute Provisions: Time for Repeal?*, 21 VA. TAX REV. 125, 136, 139–40 (2001). Because a gross-up payment is subject to income tax and additional excise taxes and is not deductible for the corporation, the decision to gross up an executive can result in a cost to shareholders that is an order of magnitude greater than the benefit to the executive. See David I. Walker, *Tax Incentives Will Not Close Stock Option Accounting Gap*, 96 TAX NOTES 851, 855 (2002). Nonetheless, a 1996 study reported that over half of CEO contracts included a golden parachute gross up provision. See Carol Bowie & Judy Fischer, *Have Parachutes Become More Than Security Blankets?*, MERGERS & ACQUISITIONS, Nov.–Dec. 1996, at 17, 19.

One lesson to be learned from this experience is that the effectiveness of tax rules (or other non-compulsory regulation) aimed at executive pay may be limited because of the significant agency problems in the pay process. Given this track record, one can readily understand why a more coercive regulatory attack on short-termism might be appealing, but, of course, the potential inefficiencies and costs of compulsory regulation would be even greater.

2. SEC Executive Pay Disclosure Requirements

The SEC's proxy disclosure rules might be viewed as another attempt to regulate executive pay. Over the last eighteen years, the SEC has steadily increased the coverage, depth, and specificity of required disclosures.⁸⁶ Currently, firms are required to provide detailed discussion and analysis of executive pay as well as numerous tables, the content of which is specified in exacting detail, including a summary compensation table that contains a bottom line total compensation figure for each of five senior executives.⁸⁷

These disclosure requirements were not directly aimed at limiting executive pay, but it is safe to say that many commentators hoped that shedding light on pay practices would result in greater restraint. There is no empirical evidence to date, however, that the proxy disclosure rules have reduced or slowed the increase in executive pay and good reason to suspect the reverse.⁸⁸ One of the suspected responses to sys-

⁸⁶ See Executive Compensation and Related Person Disclosure, Securities Act Release No. 33-8732A, Exchange Act Release No. 34-54302A, Investment Company Act Release No. 27444A, 71 Fed. Reg. 53,158, 53,160 (Sept. 8, 2006) (reviewing history of executive pay disclosure regulation and noting that regulations issued in 1992 replaced narrative discussion with tabular disclosure). The 1992 regulations actually marked a return to tabular presentation that was first mandated in the 1930s and that was replaced by narrative disclosure in the 1980s. See *id.* at 53,161.

⁸⁷ See 17 C.F.R. § 229.402 (2009).

⁸⁸ See, e.g., John M. Bizjak et al., *Does the Use of Peer Groups Contribute to Higher Pay and Less Efficient Compensation?*, 90 J. FIN. ECON. 152, 166 (2008). In a study of the effects of benchmarking CEO pay, Professors John Bizjak, Michael Lemmon, and Lalitha Naveen found that "CEOs with pay below the median of their peers receive substantially larger raises" than CEOs paid above the median. *Id.* The authors conclude that their results are consistent with an efficient system for determining the reservation wage, but they note that "benchmarking . . . could have led to greater increases in pay than would have occurred in its absence." See *id.* Professors Lucian Bebchuk and Yaniv Grinstein document a growth in executive pay between 1993 and 2003 in excess of that which can be explained by changes in firm performance. See Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, 284-89 (2005).

tematic executive pay disclosure was a kind of “Lake Wobegon” effect.⁸⁹ Company boards generally believed that their executives were above average, or believed that admitting that their executives were below average would undermine investor confidence.⁹⁰ In both cases, fuller disclosure of pay appeared to lead more often to pay increases than decreases, as low-pay firms sought to bring pay levels up at least to the average of the relevant peer group.⁹¹

Another likely response to enhanced scrutiny under the 1992 disclosure regulations was a shift in compensation from quite visible channels of pay, such as salary, stock, and options, to less visible channels, such as pensions.⁹² The 1992 disclosure regime was not comprehensive, however; it practically invited creative circumvention.⁹³ Such subterfuge is rendered less effective by the SEC’s 2006 mandate that firms disclose a bottom line figure including all channels of pay,⁹⁴ but it is probably too early to determine whether the revised rules have had any salutary effect on the overall amount of executive compensation.

There are at least two lessons to be learned from the SEC’s experience with mandatory executive pay disclosure. First, to the extent that disclosure regimes are not comprehensive, one should expect executives to creatively mitigate the impact of these rules by various circumventions, such as shifting pay channels. Second, one should be aware that even disclosure regimes can produce unintended consequences,

⁸⁹ See Rachel M. Hayes & Scott Schaefer, *CEO Pay and the Lake Wobegon Effect*, 94 J. FIN. ECON. 280, 280 (2009). Lake Wobegon, of course, is radio personality Garrison Keillor’s mythical Minnesota community where “all the children are above average.” See *id.*; see also A Prairie Home Companion with Garrison Keillor Home Page, <http://prairiehome.publicradio.org/> (last visited Mar. 5, 2010).

⁹⁰ See, e.g., Roundtable, *What’s Wrong with Executive Compensation?*, HARV. BUS. REV., Jan. 2003, at 68, 72 (relating comments of former DuPont CEO Edgar S. Woolard, Jr. that the “main reason compensation increases every year is that most boards want *their* CEO to be in the top half of the CEO peer group” in order to make “the company look strong”).

⁹¹ See Bizjak et al., *supra* note 88, at 154 (reporting that seventy-three of one hundred randomly selected companies “mention targeting at least one component of pay at or above the peer group median or mean”). See generally Hayes & Schaefer, *supra* note 89 (developing a game-theoretic model of the Lake Wobegon effect and demonstrating that the effect can lead to an upward distortion in equilibrium CEO pay under certain conditions).

⁹² See LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 95–111 (2004) (describing postretirement payments and benefits used to compensate managers).

⁹³ See *id.* at 106 (noting the SEC’s reporting requirements ended when executives retired, allowing firms to provide substantial post-retirement benefits that would never appear in publicly filed compensation tables).

⁹⁴ See Executive Compensation and Related Person Disclosure, Securities Act Release No. 33-8732A, Exchange Act Release No. 34-54302A, Investment Company Act Release No. 27444A, 71 Fed. Reg. 53,158, 53,170 (Sept. 8, 2006).

such as the upward ratcheting in pay following the imposition of the initial disclosure rules.

III. PITFALLS OF EXISTING PROGRAMS AND PROPOSALS FOR COMBATING SHORT-TERMISM

The generic challenges inherent in crafting a regulatory response to short-termism are exemplified by several specific programs and proposals that have been offered by legislators, administrators, and commentators. Moreover, these specific approaches highlight additional concerns that may arise in attempting to craft a regulatory response. Consider the following five plans, proposals, or suggestions:

- In early February 2009, the U.S. Treasury Department announced that all incentive compensation received by top executives at firms receiving “exceptional assistance” from the government would have to be in the form of restricted stock that could not vest before the government loans were fully repaid.⁹⁵ Congress modified the Treasury plan in the economic stimulus bill that it passed in mid-February 2009, the American Recovery and Reinvestment Act (“ARRA”), broadening the reach to include at least one executive of each participant in the Troubled Asset Relief Program (“TARP”), but retaining the requirement that executive bonuses be paid in restricted stock that may not vest until the loans are repaid.⁹⁶ Unlike the Treasury plan that would have capped non-incentive pay at \$500,000 per year, however, ARRA caps restricted stock incentive pay at one-third of total annual compensation.⁹⁷
- Professors Roberta Romano and Sanjai Bhagat have recently recommended that 85–90% of executive incentive pay take the form of restricted stock or restricted stock options that cannot be sold or exercised during employment or for two to four years following termination.⁹⁸ They would have the Treasury Department man-

⁹⁵ See Press Release, U.S. Dep’t of the Treasury, Treasury Announces New Restrictions on Executive Compensation (Feb. 4, 2009), available at <http://www.ustreas.gov/press/releases/tg15.htm>.

⁹⁶ See American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 516–18. The final act contains some vague language that will be open to interpretation by the Treasury Department when it writes implementing regulations. See Deborah Solomon & Mark Maremont, *Bankers Face Strict New Pay Cap*, WALL ST. J., Feb. 14, 2009, at A1.

⁹⁷ See 12 U.S.C.A. § 5221(b)(3)(D)(i)(II) (West 2001, Supp. 2009 & Supp. I 2009); Press Release, U.S. Dep’t of the Treasury, *supra* note 95.

⁹⁸ See Bhagat & Romano, *supra* note 5, at 361, 368–69.

date such a rule for firms receiving bailout funds, and they suggest that an argument can be made to extend the rule to include managers of all FDIC-insured financial institutions, but otherwise they would leave the decision to individual boards of directors.⁹⁹

- Jesse Brill, a practitioner and frequent commentator on executive pay, has proposed that executives be barred from cashing in stock until they reach age sixty-five or are two years past retirement.¹⁰⁰
- The Aspen Institute's Judith Samuelson and Professor Lynn Stout have suggested that executives be required to hold "a significant portion of their equity for a period beyond their tenure."¹⁰¹ It is not clear, however, whether they favor regulation to this effect or simply wish to encourage boards to place this restriction on executive pay.¹⁰²
- Judge Richard Posner has recently advocated that firms be required to deliver a minimum percentage of CEO pay in the form of restricted stock that could not be sold for some specified number of years.¹⁰³

Most of these approaches envision compulsory regulation, and, unless the underlying causes of short-termism are identified and corrected, some sort of coercive regulation presumably would be needed to cause boards to alter their pay practices to deter reckless behavior and earnings manipulation. As discussed in Part I, the short-termism problem, to the extent that it is a real problem, could reflect shareholder preferences resulting from market myopia or externalities, could result from managerial agency problems, or could follow from a current regulatory bias in favor of options.¹⁰⁴ This Part considers these programs and proposals as models for generally applicable, coercive regulation of executive pay, and explores the costs and risks that follow.

A. Diversification, Liquidity, and Valuation Problems Arising from Minimum Holding Periods

Each of these approaches places a minimum term on some or all incentive pay—presumably a term that exceeds current vesting prac-

⁹⁹ See *id.* at 367.

¹⁰⁰ See Mark Maremont & Joann S. Lublin, *Loopholes Sap Potency of Pay Limits*, WALL ST. J., Feb. 6, 2009, at C1 (quoting Brill).

¹⁰¹ See Samuelson & Stout, *supra* note 1.

¹⁰² See *id.*

¹⁰³ See Posner, *supra* note 5, at 1045–46.

¹⁰⁴ See *supra* notes 19–44 and accompanying text.

tices. Longer holding periods for incentive pay raise liquidity, diversification, and valuation concerns for participants. Unless one is prepared to adopt the extreme position of placing a hard cap on the total compensation received by executives, one must recognize that the associated costs would largely be borne by shareholders.¹⁰⁵ In short, there is a tradeoff between the term of executive pay and the amount of pay.

Bhagat and Romano anticipate some of these concerns. They recognize that forcing executives to hold stock and options until retirement would leave them under-diversified and facing a lack of liquidity.¹⁰⁶ Their response to the diversification concern is to suggest that the amount of equity pay would be increased to offset the greater risk.¹⁰⁷ In other words, the shareholders would compensate the executives for limiting their diversification. But there are two potential problems with this solution. First, if the compensation term had been efficiently set by the market, this combination—more pay and riskier pay—would represent an inefficient deviation for shareholders from the optimal contract. Second, whether the initial contract was optimally set or not, increasing the amount of equity pay to offset heightened risk could expose firms and executives to greater outrage over the size of executive pay packages.¹⁰⁸ As a result, it might be difficult for firms to make their executives whole on a risk-adjusted basis.¹⁰⁹

To alleviate the liquidity concern, Bhagat and Romano suggest that firms increase salaries and that Congress facilitate this practice by increasing the deductibility of executive salaries for corporate tax purposes.¹¹⁰ This fix suffers from the same defects as increasing equity pay

¹⁰⁵ Under an optimal contracting view of the pay setting process, executive compensation would be held constant on a risk and liquidity adjusted basis, and shareholders would bear virtually all of the cost of restrictions placed on vesting. See Bebchuk et al., *supra* note 36, at 761–83 (setting forth the optimal contracting view of executive compensation and detailing possible limitations). Under a managerial power view, executives might absorb a fraction of these costs since increased nominal pay, even in compensation for these burdens, could trigger investor outrage. See *id.* at 786–91.

¹⁰⁶ See Bhagat & Romano, *supra* note 5, at 367–69.

¹⁰⁷ See *id.* at 367–68.

¹⁰⁸ See Bebchuk et al., *supra* note 36, at 786.

¹⁰⁹ Shareholder outrage is a consideration if one believes that executive pay practices are not entirely the result of arm's length contracting between the board and the executives. See *id.* at 786–91. Executives might be able to deflect investor outrage over larger pay packages by pointing out that the changes were imposed upon them by government regulators. Cf. Polsky, *supra* note 82, at 905–06 (arguing that, under a managerial power model, I.R.C. § 162(m) would have provided managers with an excuse to rewrite compensation contracts in their favor).

¹¹⁰ See Bhagat & Romano, *supra* note 5, at 368–69. Bhagat and Romano also suggest that a small fraction of incentive pay (10–15%) be immediately available to executives. *Id.*

to compensate for restricting diversification and the additional risk that using salary to compensate for reduced incentive pay liquidity may actually undermine the link between pay and long-term performance.¹¹¹

Of course, even if they are compensated, executives would be tempted to hedge stock and option grants they are required to hold until retirement as a self-help means of improving liquidity and diversification.¹¹² Dean David Schizer has shown that tax and securities laws make it difficult and costly for executives to hedge their exposure to options, but that executives can readily hedge restricted stock in the period between grant and vesting.¹¹³ If the motivation is strong enough, however, executives will hedge option grants as well. Thus, steps would need to be taken to ensure that compulsory holding periods are not undermined by increased hedging.

Lengthening equity compensation holding periods would also amplify valuation problems. As several commentators have suggested, restricted stock issued by the problem banks accepting federal bailout funds resembles a stock option, because it is subordinate to the claims of the government and bondholders, and would pay off for the executives only if conditions improve significantly.¹¹⁴ Consequently, executives who are forced to accept such stock and to hold it until government loans are repaid or until their employment is terminated will reasonably value the stock like an option, i.e., as worth considerably less than the market price of the stock. Bhagat and Romano suggest that executives be given more stock to offset the value differential,¹¹⁵ but under current pay disclosure rules, the market price of this stock, not the lower option value, would be reported as the measure of executive compensation.¹¹⁶ As a result, executives in this situation would receive more of something they value less, and the gap between the value of pay perceived by the executives and the value perceived by the public would expand even more.

¹¹¹ At the extreme, firms that entirely replace incentive pay with straight salary would create no direct link between pay and long-term performance.

¹¹² Compensation would not reduce the incentive to hedge.

¹¹³ See Schizer, *supra* note 35, at 493.

¹¹⁴ See Lucian Bebchuk, Op-Ed., *Congress Gets Punitive on Executive Pay*, WALL ST. J., Feb. 17, 2009, at A15 (noting that the value of these banks' common shares "might largely represent an 'out-of-the-money option,' expected to deliver value only if things considerably improve"); Victor Fleischer, *Two Quick Workarounds on Executive Pay Caps*, CONGLOMERATE BLOG, Feb. 4, 2009, <http://www.theconglomerate.org/2009/02/two-quick-workarounds-on-executive-pay-caps.html> (observing that if restricted stock only vests after the government is paid back, the effect on executive behavior is more like that of a stock option).

¹¹⁵ See Bhagat & Romano, *supra* note 5, at 367.

¹¹⁶ See 17 C.F.R. § 229.402 (2009).

To be sure, this valuation problem would be most acute at troubled banks participating in the federal bailout programs, which are not the primary concern of this Article, but the valuation gap is not unique to troubled banks or to restricted stock. Bhagat and Romano have also proposed that executive stock options not be exercisable until two to four years following retirement.¹¹⁷ For the average CEO, they suggest, this would mean waiting for seven to nine years to exercise options.¹¹⁸ Today, options typically become exercisable three to five years following grant and are exercised soon thereafter if in the money.¹¹⁹ Given the liquidity and diversification constraints discussed above, imposing longer holding periods would significantly reduce the value of options to executives. Perversely, however, the calculated value of an option that is assumed to be exercised in eight years would be *greater* than that of an option that is expected to be exercised in five to six years.¹²⁰ At the very least, the current approach to compensatory option valuation and disclosure would need to be rethought if longer holding periods were imposed.

Of course, if executive pay is systemically too short-term focused today, some of the diversification, liquidity, and valuation costs described above are worth incurring. To the extent that agency problems result in sub-optimally short-term compensation, shareholders might benefit from regulation that increases the term of pay, even if they are forced to pay for it. Moreover, to the extent that excessively short-term

¹¹⁷ See Bhagat & Romano, *supra* note 5, at 363.

¹¹⁸ See *id.* The authors do not consider the average holding period of junior executives under their proposal, but it would certainly be longer than their estimate of the average CEO holding period.

¹¹⁹ See Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3, 35 (2002).

¹²⁰ Executive options are valued for disclosure purposes using an option pricing model. See SFAS 123R, *supra* note 38, at 40–52 (describing option valuation methodology that is used for SEC disclosure as well as financial accounting purposes). Generally, the expiration date of an option is one of the inputs to these models, and the value of an option increases with its term. See *id.* at 42–43. In order to adjust for predictable early exercise, however, the expected holding period of compensatory options (often five to six years) is substituted in these models for the contractual time to expiration when calculating value for disclosure and accounting purposes. See *id.* at 45–47. Presumably, however, if an option cannot be exercised before retirement and the expected time to retirement is eight years, that period would be used for valuation purposes resulting in greater disclosed value. Certainly, there would be no basis for choosing a shorter, counterfactual period. The root of the problem is that the current option valuation approach utilizes a rough adjustment to the models for the unique facts of compensatory options. The adequacy of this approach, however, depends on an assumption that the current, relatively short vesting periods for options do not significantly impact exercise behavior. This assumption would not be valid for executives barred from exercising options for seven to nine years.

focused pay results in negative externalities, shareholders should bear the costs of regulation that mitigates those externalities. The problem, as discussed in the next section, is that mandatory, one-size-fits-all vesting periods would be arbitrary and extremely blunt instruments.¹²¹

B. *The Problem of One-Size-Fits-All Regulation*

Part I suggests that the link between executive pay and long-term performance may be inadequate, systemically.¹²² But, even if one accepts this premise, no economic theory or empirical analysis can tell us how inadequate the link is for a particular firm, industry, or even for U.S. firms on average. Despite this fact, each approach described above involves a one-size-fits-all holding period for equity compensation. Bhagat and Romano, for example, suggest a holding period of retirement plus two to four years, which would represent at least a doubling of the average vesting period of CEO equity compensation and an even greater increase in the average vesting period of equity granted to subordinate executives.¹²³

Perhaps a dramatic shift in executive pay term along these lines is required to overcome agency problems and force companies to internalize all of the costs of short-termism. Any arbitrary holding period or periods for incentive pay raises the possibility, however, that the term will be excessive and inefficient for some, perhaps many, firms and their executives.

From the shareholders' perspective, the optimal term of executive pay would balance the costs related to diversification, liquidity, and valuation against the benefits of tying executive wealth to long-term performance.¹²⁴ The optimal term would vary considerably by industry, firm, and executive. Consider, for example, requiring executives to hold equity incentives until retirement. Although the benefit of doing so at similarly situated firms might be fairly constant, the cost would be much greater for a forty-year-old CEO than for a sixty-year-old CEO. Moreover, although the cost of this rule might be similar for two fifty-year-old CEOs, the benefit for a regulated utility company with low growth opportunities, little scope for earnings manipulation, etc., might be much less than it would be for a company like AIG. The bottom line is that

¹²¹ See *infra* notes 122–124 and accompanying text.

¹²² See *supra* notes 19–44 and accompanying text.

¹²³ See *supra* notes 117–118 and accompanying text.

¹²⁴ See Hall & Murphy, *supra* note 119, at 6 (noting that “the tradeoff between risk and incentives lies at the heart of agency theory”).

one-size-fits-all targets for executive pay term that have real bite will inevitably exceed the optimal mark for some firms and executives.

C. *Limiting Compensation Diversity*

We now turn our attention from regulation of the *term* of incentive pay to regulation of its *form*. Each of the approaches discussed would, to some extent, limit incentive pay to a specific instrument or instruments. This is troubling for several reasons. First, as this section describes, instrument-specific regulation limits the diversity of devices that firms can use in linking pay to long-term performance and potentially reduces the efficiency of compensation arrangements.¹²⁵

Consider, for example, Bhagat and Romano's proposal to limit incentive pay to restricted stock and restricted stock options.¹²⁶ Obviously the details would need to be spelled out, but if the idea behind the proposal is to limit incentives to conventional time-vested restricted stock and options, about half of current long-term incentive pay (as well as 100% of annual incentives) would be off the table.¹²⁷

Of course, the acceptable circle of incentive pay could be drawn more widely to include similar long-term incentive arrangements such as SARs (phantom stock options), performance-vested restricted stock, and performance shares (essentially phantom performance-vested restricted stock).¹²⁸ Performance vesting is generally based on accounting results,¹²⁹ which might raise concerns regarding manipulation, but, as discussed below, manipulation is less of a concern with respect to long-term incentives than annual bonuses.¹³⁰ Moreover, companies have legitimate reasons for avoiding or delaying issuing actual shares through their executive incentive programs. For example, some phantom equity plans may reflect investor concerns regarding excessive shareholder dilution from traditional stock and option plans.

¹²⁵ See *infra* notes 126–138 and accompanying text.

¹²⁶ See Bhagat & Romano, *supra* note 5, at 361.

¹²⁷ Obviously, an approach that would limit firms to restricted stock only would be even more restrictive.

¹²⁸ See FREDERICK W. COOK & Co., *supra* note 49, at 4–13. The Obama administration's February 2009 plan hinted at this possibility. See Press Release, U.S. Dep't of the Treasury, *supra* note 95 (limiting senior executive incentives at firms receiving exceptional assistance to "restricted stock or other similar long-term incentive arrangements").

¹²⁹ Although performance measures vary widely, profit measures, such as earnings per share, net income, or operating income, are frequently employed. See FREDERICK W. COOK & Co., *supra* note 49, at 18.

¹³⁰ See *infra* notes 134–135 and accompanying text.

Even if “stock” and “options” are defined broadly to include performance-vested instruments and non-equity economic equivalents, however, a compulsory approach along these lines would bar firms from utilizing pure accounting-based incentive plans. As noted above, long-term accounting-based plans currently account for almost a quarter of long-term senior executive incentives, and annual accounting-based bonuses account for about 6% of total senior executive pay.¹³¹

Of course, accounting-based incentives have been the target of a great deal of academic criticism.¹³² Annual accounting-based bonuses tend to increase managerial myopia and are subject to manipulation. Well documented, for example, is the “big bath” phenomenon, which entails managers taking operational steps to defer income and accelerate expenses when it becomes clear that annual targets will not be achieved,¹³³ thus improving the prospects for big bonuses the following year.

Opportunities for manipulation and payoffs decline as the measurement period increases, however. Accounting-based LTIPs that measure performance over three or more years should present much less of a manipulation problem than annual bonuses.¹³⁴ Indeed, such plans might actually represent a stronger commitment to long-term focus than equity grants as they insulate participants from the influence of short-term stock price fluctuations. It is, therefore, not clear that firms should be precluded from utilizing these plans.¹³⁵

Moreover, despite their drawbacks, precluding all annual incentives for executives would appear to be an overreaction to a general concern about inadequate focus on long-term performance, particularly with respect to executives junior to the CEO. Eliminating long-term accounting based incentives would certainly be problematic for this group. Although 100% equity incentive compensation might be appropriate for a CEO, who ultimately is accountable for the firm’s share price, it would not be appropriate for a subordinate executive, who is directly responsible for some facet of operations and has much

¹³¹ See *supra* notes 69–70 and accompanying text.

¹³² See, e.g., Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 739 (1995) (arguing that accounting-based bonuses encourage executives to manipulate short-term earnings).

¹³³ See STEVEN BALSAM, AN INTRODUCTION TO EXECUTIVE COMPENSATION 315 (2002) (describing the big bath).

¹³⁴ See FREDERICK W. COOK & Co., *supra* note 49, at 5–13 (detailing the prevalence of long-term accounting-based incentive plans).

¹³⁵ See Samuelson & Stout, *supra* note 1 (suggesting that “we need new ways to measure long-run corporate performance, rather than simply relying on stock price”).

less influence over the share price.¹³⁶ Finally, as discussed above, limiting incentive pay arrangements to stock and options or any other particular instruments is even more troubling when contemplated against the backdrop of lengthy new holding period requirements, given our relatively paltry experience with incentive arrangements extending beyond five years.¹³⁷

To be sure, requiring that incentives take the form of stock and options would not necessarily preclude firms from using other performance measures to determine the amount of equity compensation to be conferred on an executive or, perhaps, from maintaining accounting-based plans that simply pay out, after the requisite holding period, using vested stock as currency.¹³⁸ The existing proposals, however, appear to contemplate that executives would hold equity and be exposed to the firm's share price for an extended period. In many cases another means of linking executive wealth to long-term firm performance might be more efficient.

D. *Excessive Conservatism*

The compensation reform proposals also create a risk of a shift towards excessive conservatism. Although backlash against stock option compensation is understandable in the wake of various corporate scandals involving options, regulation along the lines of the ARRA bailout legislation or the approach endorsed by Judge Posner that would limit incentive pay to restricted stock might encourage excessively conservative executive behavior.¹³⁹ Moreover, when combined with lengthy holding periods, even approaches that allow firms to issue options or stock might lead to excessive conservatism. Policy makers should be wary of adopting regulations that discourage long-term value creation in a quest to mitigate short-termism.

As has already been shown, the appetite for risk created by a compensation basket consisting solely of cash, perks, and restricted stock is generally less than the appetite of an ordinary diversified share-

¹³⁶ This concern obviously grows in importance with the size of the executive pool subject to the regulation. For example, the restricted stock limitation under ARRA applies to more than twenty executives at some companies. See 12 U.S.C.A. § 5221(b)(3)(D)(ii)(IV) (West 2001, Supp. 2009 & Supp. I 2009).

¹³⁷ See *supra* notes 75–76 and accompanying text.

¹³⁸ For example, Bhagat and Romano state only that executive “incentive compensation plans should consist only of *restricted stock* and *restricted stock options*.” See Bhagat & Romano, *supra* note 5, at 363.

¹³⁹ See 12 U.S.C.A. § 5221; Posner, *supra* note 5, at 1045–46.

holder.¹⁴⁰ In order to overcome executive risk aversion and more accurately align long-term incentives, options are typically added to the compensation mix.¹⁴¹ Of course, executive incentives are not solely the product of current compensation.¹⁴² For example, even with a relatively conservative pay package, some executives would be encouraged to take risks in order to gain recognition and promotion.¹⁴³ Even CEOs, who are unlikely to be auditioning for better jobs, might take some risks to increase the prospects of retaining their jobs. On balance, however, pay packages lacking options could lead to undue conservatism on the part of senior corporate executives.

Although Bhagat and Romano are not explicit on this point, it is likely that their proposal to limit incentive compensation to restricted stock or options reflects the value of options in aligning long-term incentives.¹⁴⁴ This approach may represent an improvement over stock-only proposals, but even this proposal might result in excessive conservatism.

As discussed above, imposing lengthy holding periods on incentive pay reduces executive liquidity, impairs diversification, and increases the wedge between the cost of equity compensation to firms and the value to executives.¹⁴⁵ The latter two effects are more pronounced for options than they are for stock. The exposure to share price created by a \$1 million option grant may be several times greater than the exposure created by a \$1 million stock grant.¹⁴⁶ Moreover, the discount to market value assessed by non-diversified executives is greater for risky options

¹⁴⁰ See *supra* notes 53–61 and accompanying text. This statement is qualified because in the context of the bailout legislation, restricted stock might take on the incentive properties of an option and might promote risk taking. See Bebchuk, *supra* note 114; Fleischer, *supra* note 114. If the banks were liquidated as is, shareholders would get little or nothing, but if the bailout plan were a success, shareholders would participate. See Bebchuk, *supra* note 114, at A15; Fleischer, *supra* note 114. In this particular situation, the government would have better protected taxpayers by forcing the executives to take a creditor interest in the banks, rather than an equity interest. For solidly solvent firms, however, executive stock holdings promote conservatism.

¹⁴¹ See Core et al., *supra* note 53, at 33.

¹⁴² See *supra* note 79 and accompanying text.

¹⁴³ See *supra* note 79 and accompanying text.

¹⁴⁴ See Bhagat & Romano, *supra* note 5, at 361.

¹⁴⁵ See *supra* notes 105–121 and accompanying text.

¹⁴⁶ For example, at the grant date, options issued by Johnson & Johnson to its senior executives in 2007 created an exposure to share price four times greater than the exposure created by an equivalent value of restricted stock. See Johnson & Johnson, Proxy Statement (Form DEF 14A), at 44 (Mar. 12, 2008) (author's calculation based on data disclosed in proxy statement).

than stock and increases with the required holding period.¹⁴⁷ As a result, one should expect that requiring executives to hold equity compensation until retirement would shift their preferences in the direction of stock, that negotiated compensation packages would include more stock, and that all else being equal, executives would act more conservatively. In the current economic environment, of course, the prospect of executives acting more conservatively sounds attractive. The concern is that the balance could shift too far in the direction of conservatism, placing a brake on the long-term performance of U.S. companies.

E. *Risk of Circumvention*

Most of the proposals that have been discussed aim to deter short-termism by specifying the form and/or term of executive incentive pay, but not the amount or fraction of such pay.¹⁴⁸ To the extent that their plan would be compulsory, Bhagat and Romano, for example, would require that incentive pay consist of either restricted stock or restricted options that may not vest until some period after retirement, but, apparently, they would leave the mix of incentive and non-incentive pay up to individual firms.¹⁴⁹ As this section demonstrates, however, unless a floor is placed on incentive pay or a cap on non-incentive pay, mandating lengthy holding periods for incentive pay could lead to circumvention that undermines the attempt to link pay with long-term performance.¹⁵⁰ Circumvention could be avoided by placing a restriction on the amount or fraction of incentive or non-incentive pay, but doing so would magnify one-size-fits-all inefficiencies.¹⁵¹

For example, Bhagat and Romano suggest that firms should increase salaries to provide executives with liquidity to make up for the lengthy holding periods for stock and options they propose, and they suggest that the IRC § 162(m) limit on the deductibility of non-performance-based pay be increased from \$1 million to \$2 million, accordingly.¹⁵² But unless non-incentive pay is capped, firms might respond to long holding periods placed on incentive pay by reducing or even eliminating incentive pay and increasing salaries. Thus, an approach of

¹⁴⁷ See Hall & Murphy, *supra* note 119, at 36 (demonstrating the effect of increased vesting periods on the gap between company cost and the value placed on equity pay by undiversified executives).

¹⁴⁸ See *supra* notes 95–103 and accompanying text.

¹⁴⁹ See Bhagat & Romano, *supra* note 5, at 361.

¹⁵⁰ See *infra* notes 152–160 and accompanying text.

¹⁵¹ See *infra* notes 152–160 and accompanying text.

¹⁵² See Bhagat & Romano, *supra* note 5, at 368.

this sort could undermine the link between pay and long-term performance.

Although some readers might believe that the § 162(m) limit on the deduction for non-performance-based pay effectively caps non-incentive pay and would limit circumvention, this is far from clear. Today, despite their ability to qualify compensation as performance based and achieve deductibility, many firms grant non-deductible compensation to their senior executives.¹⁵³ As firms routinely state in their proxy materials, deductibility is a factor, but not a prerequisite, in designing executive pay packages.¹⁵⁴ If vesting limitations along the lines proposed by Bhagat and Romano were mandated, one would expect many firms to shift from incentive pay to salary despite the lack of deductibility under § 162(m).¹⁵⁵ Public companies would not have to abandon incentive alignment to do so. Companies could require executives to purchase firm equity on the open market as a condition of employment.¹⁵⁶

This Article does not advocate a cap on executive salaries. It simply points out that executive pay regulation taking the form of vesting limitations is undermined absent such a cap. The Treasury Department's February 2009 plan would have capped executive salaries at \$500,000 in addition to requiring that incentive pay be in the form of restricted stock.¹⁵⁷ Again, this plan was limited to bailout firms, but as a model for more general regulation it is even more problematic than the Bhagat and Romano proposal. First, this type of approach would not eliminate

¹⁵³ See Steven Balsam & Qin Jennifer Yin, *Explaining Firm Willingness to Forfeit Tax Deductions Under Internal Revenue Code Section 162(m): The Million Dollar Cap*, 24 J. ACCT. & PUB. POL'Y 300, 321–23 (2005) (finding forfeited tax deduction in 40% of firm-year observations).

¹⁵⁴ See, e.g., Eli Lilly & Co., Proxy Statement (Form DEF 14A), at 32 (Mar. 10, 2008) (stating that its “policy is to qualify our incentive compensation programs for full corporate deductibility to the extent feasible and consistent with our overall compensation objectives”).

¹⁵⁵ See Bhagat & Romano, *supra* note 5, at 368. Perversely, a \$2 million limit on deductible salary could become more of an expectation than a cap, thereby undermining the link between pay and long-term performance even at smaller firms that would not have paid salaries this large absent the § 162(m) focal point. See David G. Harris & Jane R. Livingstone, *Federal Tax Legislation as an Implicit Contracting Cost Benchmark: The Definition of Excessive Executive Compensation*, 77 ACCT. REV. 997, 1015–16 (2002) (finding that firms that paid their CEOs less than \$1 million prior to the enactment of IRC § 162(m) increased cash compensation in proportion to the gap between existing compensation and the \$1 million deduction limit).

¹⁵⁶ Shares held outside of equity compensation plans may also undermine the link between executive wealth and long-term firm performance. Unless shareholding guidelines are truly binding, these shares expose executives to short-term share price risk.

¹⁵⁷ See *supra* note 97 and accompanying text.

circumvention unless it also capped compensation in the form of perks, benefits, retirement contributions, etc. Second, if it did effectively cap all non-incentive pay, it would have gone well beyond the goal of linking pay to long-term performance. The regulation would have specified the instruments and, in the case of salary, capped the amount of one of the instruments. At this point, the plan would have eliminated almost all firm discretion and diversity related to executive pay. Given the diversity in executive age, tenure, expenses, and other factors, it should be obvious that a one-size-fits-all cap on the salary component of pay would be highly inefficient.¹⁵⁸ It should also be obvious that a sizable amount of restricted stock would be needed to compensate executives for the salary cap.

Another way to prevent circumvention would be to require that some fraction of total executive compensation awarded each year consist of incentive pay of certain specified form, as Judge Posner has recently advocated.¹⁵⁹ But the arbitrary fraction selected would impose another inefficient one-size-fits-all restriction on pay packages, and the annual nature of this restriction is also troubling. Equity compensation grants are often lumpy; they are not made every year.¹⁶⁰ Imagine a firm that has just hired a new CEO and made a large equity grant to attract the executive and align his or her incentives with shareholders. The firm may not need to grant more equity compensation in the following year. Instead, its compensation focus might turn to salary or annual incentives. Thus, an arbitrary annual specification of the fraction of compensation that must consist of long-term incentives would not only be a much poorer fit for some firms than others, it would also be a poorer fit for a particular firm in some years than in others.

IV. ARE THERE BETTER WAYS TO COMBAT SHORT-TERMISM?

Given the considerable challenges and potential negative consequences inherent in any attempt to regulate coercively the form and

¹⁵⁸ See *supra* notes 122–124 and accompanying text.

¹⁵⁹ See Posner, *supra* note 5, at 1045–46. ARRA limits restricted stock incentive pay to one-third of total compensation. 12 U.S.C.A. § 5221(b)(3)(D)(i)(II) (West 2001, Supp. 2009 & Supp. I 2009). Placing a cap on incentive pay and imposing lengthy holding periods is not likely to improve the link between pay and long-term performance. It does, however, encourage firms to repay TARP funds as quickly as possible in order to avoid this and other ARRA restrictions. See, e.g., Kate Kelly & Robin Sidel, *Goldman, Others Getting Aid Are Eager to Pay It All Back*, WALL ST. J., Feb. 5, 2009, at A10 (noting that Goldman Sachs and other companies were eager to pay back TARP funds in order to escape toughened scrutiny that complicates operations).

¹⁶⁰ See Walker, *supra* note 43, at 16–17.

term of executive compensation, it is not clear that the project should be undertaken. To be sure, minor adjustments might be made that could prove beneficial. For example, firms might be required to include effective clawback provisions in executive compensation plans that would facilitate the recoupment of bonuses predicated on inaccurate financial results that are later restated.¹⁶¹ Even if the potential benefits of further regulation do not outweigh the pitfalls, however, Congress may feel compelled to regulate more comprehensively nonetheless. Recognizing this possibility, this Part suggests that the regulatory approaches analyzed above may not strike the best balance between mitigating short-termism and avoiding harmful consequences.¹⁶² This Part, then, offers two ideas that policy makers should consider if faced with the job of crafting a regulatory response to short-termism: focusing regulation solely on the term of pay and adopting a comprehensive disclosure-based response.¹⁶³

A. Regulation of the Term of Pay But Not the Instruments

If the primary concern driving regulation of executive compensation is discouraging reckless, short-term behavior, including earnings manipulation, fraud, and bet-the-company risk taking, policy makers should consider regulating the term of pay but leaving the choice of pay instruments up to individual companies. Forcing an executive to hold stock, options, or unsecured creditor interests for a certain period should cause the executive to think twice about risking the solvency of the business. And, of course, limiting regulatory intervention to term would allow firms the leeway to choose the most efficient long-term incentives for their situation.

For example, the approach advocated by Judge Posner could be modified to require only that some fraction of pay not vest for a specified number of years, or Bhagat and Romano's approach could be modified to require only that all pay beyond salary (and perhaps a limited budget for perks) remain unvested until retirement plus two to four years.¹⁶⁴ The unvested pay could take the form of stock, an option, a long-term accounting-based incentive, or, as suggested above, even an unsecured creditor interest, such as deferred compensation.

¹⁶¹ See, e.g., 12 U.S.C.A. § 5221(b)(3)(B). Unfortunately, clawback provisions would do nothing to discourage recklessness, and so they do not represent a complete solution to short-termism.

¹⁶² See *infra* notes 164–175 and accompanying text.

¹⁶³ See *infra* notes 164–175 and accompanying text.

¹⁶⁴ See Bhagat & Romano, *supra* note 5, at 361; Posner, *supra* note 5, at 1045–46.

Alternatively, term-only regulation could be based on a comprehensive measure of the average holding period of an executive's pay package. Imagine, for example, a rule mandating a minimum four-year weighted average holding period for CEO pay. This approach would continue to ensure that executives are bound to their firms economically for an extended period, but would allow firms even greater flexibility in designing pay packages. The four-year minimum could be achieved, for example, by dividing compensation equally into current salary and stock or options that do not vest for eight years, by deferring all compensation for four years in whatever form or forms the company and executive choose, or through some other combination.

A term-only approach would permit greater diversity in compensation design and mitigate some of the harshest aspects the approaches considered above.¹⁶⁵ Allowing firms to bind executives to the long-term fortune of their companies through accounting-based incentives and even deferred cash compensation would mitigate valuation and diversification problems inherent in approaches limiting incentive pay to equity-based instruments.¹⁶⁶ A term-only approach would still have a one-size-fits-all aspect, but the greater flexibility for compensation design should mitigate inefficiencies and reduce the incentive to circumvent the regulation.¹⁶⁷

A term-only approach might have an adverse effect on executive conservatism, however. As we have seen, extending holding periods for equity pay increases the gap between shareholder cost and executive value.¹⁶⁸ As a result, the flexibility to choose between instruments would tend to result in a less risky basket of instruments and greater executive conservatism.¹⁶⁹ Naturally, the degree to which compensation risk would be reduced would depend on the length of term imposed. Requiring executives to hold pay until retirement would result in a much greater shift away from risk than requiring that a fraction of pay be held for, say, five or six years.

Given the risk of excessive conservatism, it is not certain that term-only approaches would always be superior to instrument-specific regulation aimed at combating short-termism. Nonetheless, if regulation is

¹⁶⁵ See *supra* notes 95–160 and accompanying text.

¹⁶⁶ See *supra* notes 105–121 and accompanying text.

¹⁶⁷ See *supra* notes 122–160 and accompanying text.

¹⁶⁸ See *supra* notes 114–120 and accompanying text.

¹⁶⁹ In addition, a term-only approach of this nature continues to focus only on the “flow” of incentives, not the sum total of incentives created by other equity holdings, promotional aspirations, and the like. See *supra* note 78 and accompanying text.

to be undertaken, policy makers should consider term-only approaches as alternatives to existing instrument-specific proposals.

B. *Disclosure-Based Regulation*

This Article has focused on compulsory regulation aimed at improving the link between executive pay and long-term company performance, and, to the extent that short-termism is a result of market myopia and/or externalities, it seems likely that some degree of coercion probably would be needed to effect change.¹⁷⁰ Enhanced disclosure of executive pay practices, for example, is unlikely to result in firms increasing holding periods if shareholders prefer the current arrangements. Unfortunately, highly coercive regulation carries the greatest collateral risks and costs. One-size-fits-all regulation inevitably involves some over-inclusiveness, and firms have little choice but to comply with compulsory regulation.¹⁷¹

On the other hand, to the extent that short-termism is driven by managerial myopia and agency problems, there *might* be a useful role for enhanced disclosure.¹⁷² Were it not for the opacity of complex and diverse compensation arrangements, so this story goes, boards and shareholders would adjust compensation arrangements to increase the link between executive wealth and long-term company performance (or at least the link between executive wealth and company solvency).

The average holding period of pay discussed in the previous subsection might provide a reasonable basis for a disclosure-based regime.¹⁷³ In order to avoid the type of circumvention that plagued the SEC's former piecemeal executive pay disclosure requirements, disclosure of the term of executive pay should be comprehensive, and disclosure of an average holding period that includes every element of compensation would be comprehensive.¹⁷⁴

¹⁷⁰ See *supra* notes 25–29, 37 and accompanying text.

¹⁷¹ Of course, one way of ratcheting down the potential harm of such regulation is to lower the stakes by converting compulsory rules into tax or tax-like incentives. Unfortunately, as we have seen, previous attempts at using the tax code to regulate executive pay have been less than fully successful. See *supra* notes 81–85 and accompanying text.

¹⁷² See *supra* notes 30–36 and accompanying text.

¹⁷³ See *supra* notes 166–169 and accompanying text.

¹⁷⁴ See *supra* notes 86–94 and accompanying text. The other negative consequence of disclosure of executive pay amounts was an upward ratcheting in the value of pay packages, but there is no reason to think that the *term* of executive pay would be subject to a Lake Wobegon effect. See *supra* notes 89–90 and accompanying text. Arguably, better executives should be paid more, but not more quickly or more slowly than their peers.

One can, in fact, imagine a range of possible disclosure metrics extending from a simple weighted average holding period, which would serve as a measure of protection against bet-the-company risks, to more complex measures involving both the term of pay and sensitivity of pay to performance. The potential benefits of such disclosure would include facilitating comparison between firms on the extent to which executive pay packages are focused on the long term, providing baseline data and context to administrators evaluating more coercive regulatory proposals, giving outside directors ammunition in negotiating pay packages with senior executives, and giving shareholders who have a “say on pay” a consistent basis for evaluating the term as well as the amount of executive compensation proposed by the board of directors.¹⁷⁵

A disclosure-based approach to combating short-termism would minimize the collateral damage from regulation, but disclosure alone is unlikely to have the same effect on compensation design and short-termism as more coercive regulation. That is the tradeoff. Whether it is a good tradeoff depends on the extent and ultimate source of the short-termism problem. Given the considerable uncertainty on both counts, however, caution is warranted in drafting any potential regulations.

CONCLUSION

If combating earnings manipulation and reckless short-term behavior were the only issues involved, crafting a regulatory response to short-termism would be a fairly easy task. It is not difficult to bind executive wealth to long-term firm performance and deter managers from risking the solvency of their companies. But shareholders and policymakers care about more than solvency. They are also interested in the efficiency of compensation and in encouraging executives to take appropriate

¹⁷⁵ “Say on pay” procedures give shareholders an advisory, up-or-down vote on executive compensation. As of March 2009, nineteen U.S. companies had voluntarily adopted “say on pay” procedures, and large numbers of shareholders have voted in support of “say on pay” at many other companies. See Ted Allen, “*Say on Pay*” Gets 62% Support at Hain Celestial, Risk-Metrics Group Risk & Governance Blog, <http://blog.riskmetrics.com/gov/2009/03/say-on-pay-gets-62-support-at-hain-celestialsubmitted-by-ted-allen-publications.html> (Mar. 12, 2009, 12:10 EST). ARRA requires TARP recipients to submit executive compensation to an annual non-binding shareholder vote. See 12 U.S.C.A. § 5221(e)(1)–(2) (West 2001, Supp. 2009 & Supp. I 2009). There is also support in Congress for requiring “say on pay” more generally. See Stephen Labaton, *Democrats Seek Shareholder Voting on Executive Pay*, N.Y. TIMES, Apr. 19, 2007, at C2 (noting the House debate on a bill that would give shareholders the right to a nonbinding vote on the pay packages of senior executives of public companies as well as on “golden parachute” compensation awarded to executives during negotiations over the purchase or sale of a company).

risks that maximize the long-term prospects of companies. These conflicting priorities result in a difficult balancing act, too difficult, perhaps, to be the subject of one-size-fits-all, coercive regulation.

Nonetheless, despite the lack of empirical evidence, the author shares the view that executive pay probably is too focused on the short term systemically, as a result of managerial agency problems and opacity, and thus is among those frustrated by the barriers to fruitful coercive regulation. So what else can be done to reduce short-termism? First, we can work to mitigate the underlying agency problems through improved board structure and governance practices,¹⁷⁶ and we can directly address the other potential underlying causes of short-termism, such as market myopia, through education, market reforms, and improved reporting.¹⁷⁷ Second, we can employ less coercive means of encouraging firms to increase the long-term focus of executive pay that will minimize unintended consequences. Comprehensive disclosure of the term of executive pay might be one approach. Another would be increased pressure on firms from congressional committees and proxy advisors to extend incentive holding periods.¹⁷⁸ Persuasion would be more effective, of course, if also backed by empirical evidence linking longer incentive holding periods with reduced executive risk taking and enhanced firm performance. Reforming executive compensation is no easy task and legislators should proceed with caution, seeking improvement, but forgoing radical measures that jeopardize economic growth.

¹⁷⁶ See, e.g., RISKMETRICS GROUP, U.S. CORPORATE GOVERNANCE POLICY 2009 UPDATES 4–13, 22–33 (2008), available at <http://www.riskmetrics.com/sites/default/files/RMG2009PolicyUpdateUnitedStates.pdf> (outlining board structure and governance best practices).

¹⁷⁷ See, e.g., Alfred Rappaport, *The Economics of Short-Term Performance Obsession*, 61 FIN. ANALYSTS J., May–June 2005, at 65, 70 (proposing improved corporate performance reporting, focused on accruals, as a means of reducing obsession with quarterly results).

¹⁷⁸ Currently, proxy advisor RiskMetrics Group's statement of executive compensation best practices includes only vague language that five-year equity vesting "do[es] not necessarily provide a long-term focus" but that forcing executives to hold stock until retirement "can encourage a long-term focus." See RISKMETRICS GROUP, *supra* note 176, at 28–29.