Executive compensation reform should lead to policies that are simple, transparent, and focused on creating and sustaining long-term shareholder value. We suggest that executive incentive compensation plans should consist only of restricted stock and restricted stock options, restricted in the sense that the shares cannot be sold or the option cannot be exercised for a period of at least two to four years after the executive’s resignation or last day in office. This will provide superior incentives for executives to manage corporations in investors’ longer-term interest, and diminish their incentives to make public statements, manage earnings, or accept undue levels of risk, for the sake of short-term price appreciation.

Executive compensation is widely criticized for being excessive and for providing perverse incentives for reckless conduct. The issue has moved from the agenda of shareholder activists and media commentators to that of the federal government, in the ongoing financial crisis that has led to large-scale government financial intervention in the private sector. For instance, the financial services industry rescue legislation, the Emergency Economic Stabilization Act of 2008, (“EESA”) had several provisions directed at limiting executive compensation in companies from which the Treasury Department was to acquire troubled
assets.\(^1\) As the rescue program has transmuted into government purchase of equity interests in financial institutions instead of assets, rendering the EESA provisions apparently inapplicable, calls have steadily increased to restrict the compensation of executives of institutions receiving government funds. Most recently, legislation has been introduced in the House that would prohibit incentive compensation for those financial institutions’ executives, and in the Senate that would cap those executives’ compensation at $400,000 (the salary of the President of the United States).\(^2\) The “rhetorical assault” by President Obama of Wall Street executives’ bonuses as “shameful” echoes those sentiments.\(^3\)

Given the sour public mood in a deteriorating economy, additional attempts to restrict executive compensation can be expected, and they may extend beyond the financial sector that has been the recipient of government funds.\(^4\) Accordingly, we take this opportunity to review briefly the debate on executive compensation and suggest an approach to executive compensation that will better align incentives with investor interest. Rather than limit compensation to a dollar amount or prohibit bonus payments, compensation approaches that the academic literature indicates would be imprudent and counterproductive,\(^5\) we recommend instead altering the form in which equity-based incentive compensation is provided to restricted


\(^3\) Lucchetti & Kamitschnig, supra note 2.

\(^4\) For example, at the Senate confirmation hearing of incoming Treasury Secretary Timothy Geithner, the committee chairman, Senator Carl Levin, asked the Secretary whether he would favor extending to all U.S. corporations and all employees, the EESA provision that caps a corporation’s income tax deduction for an executive’s compensation of any form at $500,000 (compared to the current $1 million limit, that does not apply to incentive compensation). Executive Compensation: Geithner Gives Glimpse of Policy on Executive Compensation under TARP, 7 Corp. Accountability Rep. (BNA) 125 (Jan. 30, 2009).

\(^5\) See text and accompanying notes 23-25, infra.
stock, that is, equity interests that an executive could not sell until a specified number of years – we would suggest two to four -- after he or she leaves a firm. We think that form of compensation will provide managers of publicly-traded corporations with the proper incentives to operate the business in investors’, and society’s, interest. We would leave the decision to implement such a compensation policy in the hands of management and investors, along with the specific duration of the selling restriction, so that the particulars of employment could be tailored to specific firms’ and individuals’ needs. We would, however, recommend that the Treasury Department require that such a compensation package be adopted by firms receiving government assistance. As we discuss below, our proposal is similar to, but somewhat more stringent than, current ideas regarding limits on those firms’ executive compensation being floated by the Obama administration.

I

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

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6 For a discussion of the need to tailor corporate governance mechanisms to individual firms’ requirements see Sanjai Bhagat et al., The Promise and Peril of Corporate Governance Indices, 108 Colum. L. Rev. 1803, 1858-59, 1862-63 (2008).
7 See text and accompanying notes 17-18, infra.
only to non-incentive-based compensation. Moreover, an influential study by Michael Jensen and Kevin Murphy lent support to this view by documenting what the authors considered to be trivial responsiveness of executive compensation to stock performance: they calculated that CEO compensation changed by only $3.25 for a $1,000 change in stock value. Jensen and Murphy viewed this disconnect to be a matter of considerable policy concern and advocated increasing equity incentive compensation. Brian Hall and Josh Liebman documented a significant increase in incentive compensation since the publication of Jensen and Murphy.

However, the tide of popular opinion turned against equity and option-based compensation after the Enron and other corporate accounting scandals came to light, fueled by repeated assertions in the media from journalists, political officeholders, commentators, and public and union pension funds that executive compensation is unreasonably high. The heated rhetoric has only intensified with the political backlash to the financial panic and crisis, which began in 2007, and the government bailout of financial institutions commencing in 2008. This turn of events is not an altogether surprising development, as executive compensation has a long history of being targeted by populist attacks following market declines and scandals. The

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9 IRC §162(m). The provision was enacted in 1993 as part of the Omnibus Budget Reconciliation Act, at a time of public criticism of executive compensation. See, e.g., Nancy L. Rose & Catherine Wolfram, Regulating Executive Pay: Using The Tax Code To Influence Chief Executive Officer Compensation, 20 J. Labor Econ. S138 (2002). Some commentators have attributed the Enron and related corporate scandals to that legislation: The contention is that, because managers could only receive substantial compensation in the form of stock and stock options, they had incentives to engage in accounting manipulation to maintain high stock prices. E.g., Bruce Bartlett, Not So Suite: Clinton Tax Law is Problem, Not Greedy Execs, National Review online (Sept. 25, 2002), available at http://www.nationalreview.com/nrof_bartlett/bartlett092502.asp.


13 See Michael C. Jensen & Kevin J. Murphy, Performance Pay and Top-Management Incentives, Working Paper 43 (June 4, 1989) (listing newspaper headlines attacking high executive compensation
accounting scandals revived executive compensation as an issue because some scandal-ridden firms’ executives reported gains in the range of tens and hundreds of millions of dollars from exercising stock options before their firms imploded. Similarly, executives and employees of the financial institutions being aided by the government received billions of dollars in equity incentive compensation in the years running up to the current crisis, and some continued to receive large bonuses while their firms were suffering billions of dollars in losses.\(^\text{14}\)

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

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incentives to make public statements, manage earnings, or accept undue levels of risk, for the sake of short-term price appreciation.

II

The idea of using restricted stock for executive incentive compensation is not original to us, but it is an approach that has been lost in the current populist agitation to reduce, rather than restructure, incentive compensation. For instance, many companies have restricted stock plans, the use of which began to increase after stock options were required to be expensed in firms’ financial statements, thereby equalizing the accounting treatment of the two forms of compensation.\textsuperscript{15} That change gave an edge to using restricted stock over options: with restricted stock, an employee still receives something of value if the stock price declines post-grant, compared to what would be a worthless under-water option.\textsuperscript{16} However, existing restricted stock plans differ from our proposal in an important respect: the vesting requirement is typically three years and the executive must still be employed at the end of the vesting period to receive the award. In addition, the Obama administration is currently considering requiring financial institutions receiving government funds to use, for compensation above a threshold, a form of restricted stock or something similar that could not be sold until the government is repaid.\textsuperscript{17}

Our proposal to require executives to hold their shares until several years after they leave a firm will diminish the perverse incentives yet retain the benefits of equity-based incentive compensation plans. Managers with longer horizons will, we think, be less likely to engage in

\textsuperscript{15} Martin E. Personick, IRRC Governance Research Service 2005 Background Report A: Management Proposals on Executive Compensation Plans 8 (Apr. 2005) (predicting trend to increased use of restricted stock and providing rationale); Martijn Cremers & Roberta Romano, Institutional Investors and Proxy Voting: The Impact of the 2003 Mutual Fund Voting Disclosure Regulation 16 (unpublished manuscript 2008) (reporting significant increase in use of restricted stock before and after 2003 announcement that options would have to be expensed in 2005). All other things being equal, companies preferred compensation that was not expensed under accounting rules because that increased reported earnings.

\textsuperscript{16} Personick, supra note 15, at 8.

\textsuperscript{17} Executive Compensation, supra note 4.
imprudent business or financial strategies or short term earnings manipulations when the ability to exit before problems come to light is greatly diminished. Supporting our contention, Natasha Burns and Simi Kedia find, for example, that as a CEO’s ownership of restricted stock increases, a company is less likely to be involved in financial misreporting. In this regard, our proposal is similar to, but goes beyond the term of the restricted stock concept that is being floated by the Obama administration for government-assisted financial institutions. We would encourage the administration not only to continue to pursue its proposal but also to consider requiring those financial institutions to implement restricted stock plans whose duration will last a specified period – such as our suggested two to four years, but left up to the institution -- beyond an employee’s departure if it occurs after the government is repaid. Indeed, the argument can be made to mandate the use of restricted stock plans as the sole form of incentive compensation for managers of financial institutions whose liabilities are guaranteed by the government through the federal deposit insurance program, and not simply those receiving EESA funds, to align managerial incentives against excessive risk-taking and thereby protect the public fisc.

We note three caveats to the proposal. First, if executives are required to hold the restricted shares and options, then they would most likely be under-diversified. This would lower the risk-adjusted expected return for the executive. One way of bringing the executive’s risk-adjusted expected return to the former level (that before the executive was required to hold the shares and options) would be to increase the expected return by granting additional (restricted) shares and options to the executive. To ensure that the incentive effects of restricted stock and options are not undone by self-help efforts at diversification, executives participating in these compensation plans should be prohibited from engaging in derivative transactions, such as equity

swaps, or borrowing arrangements, that enable them to hedge their interest in the restricted shares.

Second, and related to the first, if executives are required to hold the restricted shares and options, then they would raise concerns about lack of liquidity of their compensation. To put this in perspective, our proposal requires executives to not sell their shares or exercise their options for a period of at least two to four years after their last day in office. The median tenure of CEOs in larger U.S. corporations is about five years. Hence, on average, a CEO can expect to wait about seven to nine years before being allowed to sell shares or exercise options. To offset this loss of liquidity we propose a higher limit on cash compensation for tax deductibility purposes, up to say, $3 million compared to the existing $1 million limit (for executives who receive equity compensation in the form of restricted stock). We also note a parallelism between our proposal and compensation in the non-publicly held corporation setting, which provides additional support for our proposal: it is quite common for those firms’ top executives to wait for seven to ten years before receiving a substantial portion of their compensation for work done earlier. For instance, the general partners of private equity partnerships typically receive their compensation in two parts: the first part is a management fee which is about 2 percent annually of the committed capital they are managing. The second part of the compensation is carried interest which is a fraction (usually, 20 percent) of the lifetime profits

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19 The executive would also be exposed to the impact of decisions made by the new executive; however, these future decisions are perhaps equally likely to increase or decrease the share price. Additionally, this will provide the executive with succession planning incentives.
21 I.R.C. 162(m). We would therefore undo the decrease in the deduction contained in the EESA, and counsel against the suggestion for expanding the reduction in deductibility to all firms see note 4, supra.
generated by the private equity partnership. Most of these profits are realized towards the end of the life of such partnerships, usually seven to ten years.22

Third, to the extent an executive incurs tax liability from receiving such restricted shares and options, he or she should be allowed to sell enough shares (and/or exercise enough options) to pay those additional taxes.

III

The rescue legislation and recently-introduced bills’ limits on executive compensation may quench the public’s anger but they are not a solution to compensation providing poor incentives. More important, empirical research indicates that companies find a way to circumvent congressional limitations on compensation, and the result is invariably higher and more opaque compensation, as adjustments are made to pre-regulation optimal compensation contracts; those adjustments can and have created perverse incentives for executives. For example, after Congress restricted the income tax deductibility of non-equity-incentive-based cash compensation to $1 million, firms altered the mix of compensation to reduce cash salaries and increase incentive compensation.23 One cannot but appreciate the irony that congressional action to reduce executive pay would appear to have precipitated the mushrooming of equity incentive compensation, the bulk of which accounts for the very large amounts paid to executives that are the present object of attack, and that may have provided executives with increased incentives to engage in accounting improprieties (to maintain the value of their stock

options). A similar reorientation of pay packages with perverse consequences occurred after the Sarbanes-Oxley Act of 2002 required clawbacks of incentive-based compensation were a firm’s financials to be restated: companies increased non-forfeitable fixed-salary compensation and decreased incentive compensation, thereby providing insurance to managers for increased risk. As critics of executive compensation, including President Obama, object to large pay packages that are independent of performance, firms’ adaptation to the clawback provisions had precisely the opposite effect of what they would wish to see of a pay package. By contrast, our proposal that allows only restricted stock and restricted stock option as incentive compensation will provide superior incentives for executives to manage corporations in investors’ longer-term interest, while avoiding the perverse incentives of both an artificial cap on compensation and of unrestricted stock and option compensation plans.

24 Burns & Kedia, supra note 18, at 63 (finding CEO compensation in stock options is significantly related to accounting restatements). But see Christopher S. Armstrong et al., Chief Executive Officer Equity Incentives and Accounting Irregularities 1-2,11 (unpublished manuscript 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1132411 (using a different statistical technique, finds no relation between any form of CEO equity incentive compensation and accounting improprieties). However, to the best of our knowledge, none of the publicly-held companies have an executive compensation policy like the one we are recommending here. Hence, companies in neither the Burns and Kedia sample, nor the Armstrong et al sample have executive compensation policies that allows only restricted stock and restricted stock option as incentive compensation.

25 Daniel A. Cohen et al, The Sarbanes-Oxley Act of 2002 : Implications for Compensation Structure and Managerial Risk-Taking (unpublished manuscript 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027448. While it is unlikely that pay levels in the financial services sector will be as high in the future as they were in the past, Cohen et al.’s research suggests that it is highly probable that the industry compensation structure will change to include higher base pay to offset reduced bonuses in response to the publicly-expressed outrage at bonus payments by the President and others, supra note 2.