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

Sanjai Bhagat
University of Colorado at Boulder
and
Roberta Romano
Yale University, NBER

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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.
Proposal will provide superior incentives compared to unrestricted stock and option plans 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.
Proposal also superior to limits on compensation or prohibitions of bonus payments (congressional proposals)

Empirical research indicates that companies find a way to circumvent congressional limitations on compensation, with result invariably higher and more opaque compensation and adjustments with perverse incentives

  e.g., Large increase of equity incentive compensation followed enactment of limit of tax deduction of cash compensation to $1 million, which some studies relate to subsequent accounting restatements and fraud; Enactment of clawbacks of incentive pay increased non-forfeitable fixed salary components, providing insurance to executives for increased risk.
Caveats - 1

If executives are required to hold the restricted shares and options, then they would most likely be under-diversified.

Problem: Lowers the risk-adjusted expected return for the executive.

Solution: Grant additional (restricted) shares and options to the executive.

– Prohibition against engaging in derivative transactions, such as equity swaps, or borrowing arrangements, that hedge payoff from restricted shares/options.
Lack of **liquidity** of executive’s compensation.

Median CEO tenure: About 5 years.
CEO can expect to wait about seven to nine years before being allowed to sell shares or exercise options.

*Note: This parallels time frame of realization of significant portion of private equity general partner’s profits (carried interest realized toward end of partnership life, usually seven to ten years).*

Solution: **Higher limit on tax-deductible cash compensation** of, say, $3 million.
Caveats – 3

**Tax liability** from receiving such restricted shares and options.

Solution: Executive allowed to sell enough shares (and/or exercise enough options) to pay those additional taxes.
Conclusion

Our proposal, allowing *only* restricted stock and options as incentive compensation

will *provide superior incentives* for executives to manage corporations in investors’ long-term interest

while *avoiding the perverse incentives* of both an artificial cap on compensation and of unrestricted stock and option compensation plans