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Executive Compensation

Despite reforms, pay is less transparent and shareholder-friendly than in the past.

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By all appearances, executive compensation reform is on the march. New Securities and Exchange Commission rules governing disclosure and the mandatory expensing of stock options have both come on line in the past two years, and legislation that would have given shareholders a "say on pay" passed the U.S. House of Representatives last session. Institutional investors have also found their voice, passing resolutions calling for shareholder advisory votes on compensation and other changes in process and policy.

While these developments have no doubt left compensation committee members feeling the warm breath of reformers on the backs of their necks, the biggest developments of the past several years cut very much the other way. The rise of time-vested restricted stock and a "portfolio" approach to incentive compensation are resulting in executive pay that is at least as generous, but fundamentally less transparent and shareholder-friendly, than in the past.

Recent Reforms

The reforms should not be minimized. FAS 123(R),[1] which became effective in 2006, mandated that companies record the "fair value" of stock options and other equity-based compensation as an expense on their income statements, and has had its intended effect of changing boards' inclination to view equity-based compensation as "free money."

The new rules governing executive compensation disclosures, completely rewritten for the 2007 proxy season, now require that companies fully explain their executive pay policies in a Compensation Disclosure and Analysis (CD&A) report and extensively revised tables, representing a major improvement over previous disclosures.[2] The SEC has also shown commitment to the new rules, responding to 2007 proxies that did not fully embrace the intended spirit of transparency by sending several hundred letters to companies with helpful suggestions for 2008.[3] The SEC is also piloting a Web site that makes key compensation data readily accessible through a user-friendly interface, as part of its XBRL data tagging program.[4]

Other initiatives are brewing. Last year, legislation requiring companies to submit executive compensation to a non-binding shareholder vote—a so-called "say on pay"—was reintroduced by House Financial Services Committee Chairman Barney Frank and passed the U.S. House of Representatives by a substantial margin.[5]

Institutional shareholders are also taking matters into their own hands, with an informal network of investors led by the American Federation of State, County and Municipal Employees and Walden Asset Management seeking precatory "say on pay" resolutions in more than 90 companies' proxies this year, up from 47 last year and seven the year before. Last year, several of these non-binding resolutions received majority votes for the first time. Other union pension funds are also advocating substantive and process reforms, including closer linkage of pay to performance, use of independent consultants, and policies designed to prevent Rule 10b5-1 trading plan abuses.[6]

While all of these efforts have their detractors,[7] studies of the market's reaction to compensation reforms—evaluated through event studies calculating "abnormal" returns around announcement days—often show favorable share price responses.[8]

The Reaction—Changes in Form and Design

While the reforms have been significant, their importance pales beside the broad, countervailing changes in compensation practices over the past several years: the rise of time-vested restricted stock and growing use of "portfolios" combining multiple types of incentives.

Through the 1990s, stock options dominated long-term incentive compensation and their use grew sharply, spurred by reformers who argued that managers should be paid for performance—measured by share price gains—rather than like bureaucrats. Today, however, companies are increasingly replacing options with grants of restricted stock, i.e., full value shares for which executives do not pay any exercise price. Many of these grants are simply "time-vested," that is, awarded based solely on continued employment and without the need to achieve a performance target.

The result has been a fundamental shift from an incentive structure that sought to closely link pay with share price appreciation, to one where large "incentive" payouts can occur even when a stock performs abysmally.

Given that all sides in the executive compensation debate endorse strong links between pay and performance—one of the few areas of common ground—this shift is striking.

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The demise of options stems largely, it turns out, from earlier reform efforts.

The trend away from options began after the corporate scandals early in the decade, as investors began to question pay policies and the press ran stories sharply criticizing perceived excesses resulting from large option grants. Restricted stock does not lead to the same newsworthy payouts because fewer full-value shares are granted, reducing the upside from share price growth. Executives, for their part, are willing to accept the reduced appreciation potential in exchange for downside protection: by its nature, restricted stock retains all or most of its value if a stock price stays flat or declines somewhat.

The movement away from stock options was also spurred by other criticisms. Options were faulted for leading to a myopic focus on short-term results at the expense of long-term value creation. They were also blamed for encouraging fraud by creating an incentive for executives to mislead the market in order to raise share prices and then cash out. Finally, options were criticized as imperfect incentives because a declining share price leaves them out-of-the-money, and underwater options have a severely demoralizing effect.

The adoption of mandatory stock option expensing in 2006 significantly accelerated the trend away from stock options. As intended, recording options' "fair value" as a charge against earnings made boards far more sensitive to their cost and shareholders far more aware of their companies' largess. Rather than simply reducing the size of option grants, however, boards responded by looking for cheaper alternatives.

Options, it turns out, are unusually expensive. First, this is because Black-Scholes and other widely used option pricing models, developed for freely transferable, market-traded options, appear to significantly overstate the fair value of nontransferable employee stock options. Second, options' cost results from their inherent riskiness—their value depends on stock price appreciation. Because executives, like everyone else, are inherently risk-averse, they value options far less than forms of compensation with a relatively certain payout, such as time-vested restricted stock.

While boards' desire to reduce compensation costs is understandable, the main source of options' high cost is inherent in any form of performance-contingent pay. The risk of non-payment that depresses options' perceived worth in the eyes of executives is precisely the feature that generates the incentive effects for which they are universally valued. Like the Plotnick Diamond,[9] their benefits—strongly aligning executives' interests with shareholders—are unavoidably tied to their associated burden of high cost relative to other forms of compensation. By substituting restricted stock for options, compensation committees have reduced compensation costs, but only at the expense of eliminating the essential incentive effect that provided the rationale for making large equity-based grants in the first place.

The move away from options has been accompanied by a second and related trend—the replacement of straightforward option awards with complex "portfolios" of incentives. In addition to time-vested restricted stock, these include: stock appreciation rights, restricted stock units, performance shares, multiyear performance-dependent cash bonuses, and stock purchase plans with employer matches. Each of these offers different combinations of incentive effects, performance-sensitivity, accounting and tax treatment, and stock dilution impact. In addition, some require shareholder approval while others do not.

Incentive awards have been further complicated because many are tied to metrics other than stock price, such as revenue, earnings-per-share growth, or returns on capital. Selection of appropriate performance targets for each metric then adds further complexity, and if a board chooses to set goals relative to peers, it must then take the further step of determining which companies or indices to use as benchmarks.

While the "portfolio" approach allows companies broad flexibility to create customized, targeted incentives, this flexibility comes at a heavy cost to transparency. It also invites abuse. Some pay critics have noted that historically, companies and compensation consultants have tried to "camouflage" pay through devices such as retirement plans, company loans, and perquisites,[10] and the increased complexity of current pay arrangements, whatever the motive, has a similar effect. Notably, one area of special controversy in developing the SEC's new disclosure rules was whether companies should be required to disclose performance targets. Corporate commenters opposed disclosure on the grounds that such targets were proprietary information whose disclosure would result in a competitive disadvantage.[11]

In addition to removing transparency, complex incentive "portfolios" also preclude investors from later policing whether performance targets were adhered to. Post-hoc adjustments have unfortunate precedent in the realm of executive compensation, reflected in the former practice of repricing options and forgiving company loans. In a recent case litigated by the author, a shareholder-friendly "double-triggered" change-in-control provision (requiring termination of the executive after a change in control) was modified on the eve of the company's sale to eliminate the second trigger.

Missed Opportunities

The shortcomings of restricted stock and incentive "portfolios" are even starker when compared to changes that could have been made to address legitimate concerns about options, while strengthening alignment with shareholder interests at the same time.

First, concern about option-induced short-termism could have been addressed far more effectively by requiring executives to retain a portion of the shares they acquire through option exercises. Studies have strongly correlated executive stock ownership with superior shareholder returns.[12] Retention requirements also provide a significant disincentive to achieve growth through fraud, aggressive accounting, or other unsustainable practices. Stock ownership could be further enhanced by requiring executives to purchase and retain company shares with a percentage of their annual bonuses.

Second, the problem of the de-motivating impact of underwater options can be largely addressed—along with the opposite problem of windfalls from market-wide or industry gains—by indexing option strike prices to a recognized industry benchmark. Market or industry declines would then be reflected in a lower strike price, preventing the options from falling underwater for reasons other than company-specific performance, and placing options in-the-money if the company outperformed its peers.

While share retention requirements and indexed options are both recognized reforms whose merit is generally accepted, neither has been widely adopted.

Conclusion

Notwithstanding the reforms of the past several years, executive pay is less transparent and less aligned with shareholder interests than in the past. It is not too late, however, to reverse the trend and adopt policies that address options' limitations and improve the important incentives they provide.

1. Financial Accounting Standards Board, "Statement of Financial Accounting Standards No. 123 (revised 2004)—Share-Based Payment" (December 2004).
2. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (Sept. 8, 2006) (principally codified in Item 402 of Regulation S-K, 17 CFR §229.402).
3. The SEC staff's general comments are set forth in "Staff Observations in the Review of Executive Compensation Disclosure," Oct. 9, 2007, available at http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm.
4. The Web site may be accessed at http://216.12.130.224.
5. The Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong. (2007), passed by a vote of 269 to 134 on April 20, 2007.
6. See Barry G. Sher & Kenneth Breen, "Increased SEC Scrutiny of 10b5-1 Plans on Horizon?" NYLJ, Dec. 3, 2007.
7. Pay activism is comprehensively critiqued in Ira T. Kay & Steven Van Putten, "Myths and Realities of Executive Pay," 47-70 (2007).
8. E.g., Jie Cai & Ralph A. Walkling, "Shareholders' Say on Pay: Does It Create Value?" December 2007, available at http://ssrn.com/abstract=1030925 (correlating positive abnormal returns around passage of H.R. 1257 with above-normal executive pay); Fayez A. Elayan, Kuntara Pukthuanthong & Richard Roll, "To Expense or Not to Expense Employee Stock Options: The Market Reaction," 2004, available at http://repositories.cdlib.org/anderson/fin/12-04/ (correlating positive abnormal returns to voluntary adoption of stock option expensing).
9. An old joke recognizing the need to accept benefits with their associated burdens. The joke is told well at http://www.jewishmag.com/42MAG/HUMOR/humor.htm.
10. Lucian Bebchuk & Jesse Fried, "Pay Without Performance: The Unfulfilled Promise of Executive Compensation," 67-70 (2004).
11. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. at 53,166-67.
12. Kay & Van Putten, supra note 7, at 110-11.